(23)

No. 92-1384

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1993

BARCLAYS BANK PLC,
Petitioner,

VS.

FRANCHISE TAX BOARD,
AN AGENCY OF THE STATE OF CALIFORNIA,
Respondent.

On Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

JOINT APPENDIX — VOLUME II

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Certiorari Granted November 1, 1993

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96TH CONGRESS — SENATE — EXECUTIVE REPT.
1st Session — No. 96-5

THIRD PROTOCOL TO THE 1975 INCOME TAX CONVENTION WITH THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND, AS AMENDED

REPORT

OF THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

ON

EXECUTIVE Q, 96TH CONG., 1ST SESS.

THIRD PROTOCOL TO THE
1975 INCOME TAX CONVENTION
WITH THE UNITED KINGDOM OF
GREAT BRITAIN AND
NORTHERN IRELAND, AS AMENDED

June 15, 1989, — Ordered to be printed
(Under authority of the order of the Senate of June 14, 1979.)

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON: 1979

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96TH CONGRESS *1st Session* | SENATE | EXECUTIVE REPT. No. 96–5

[p. 1] THIRD PROTOCOL TO THE 1975 INCOME TAX CONVENTION WITH THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND, AS AMENDED

JUNE 15, 1979.—Ordered to be printed
(Under authority of the order of the Senate of June 14, 1979.)

MR. CHURCH, from the Committee on Foreign Relations, submitted the following

REPORT

[To accompany Ex. Q, 96th Cong., 1st sess.]

The Committee on Foreign Relations, to which was referred the Third Protocol to the 1975 Tax Treaty with the United Kingdom of Great Britain and Northern Ireland for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains (Executive Q) (referred to as the proposed protocol), having considered the same, reports favorably thereon without reservation and recommends that the Senate give its advice and consent to ratification thereof.

I. PURPOSE

The proposed third protocol to the proposed income tax treaty between the United States and the United Kingdom deals with issues which arose during the previous consideration of the treaty by the United States Senate and with other matters raised during discussion of those issues between the United States and the United Kingdom.

* * *

[p. 5] VII. EXPLANATION OF PROTOCOL PROVISIONS

A comprehensive article-by-article explanation of the proposed protocol to the proposed income tax treaty between the United States and the United Kingdom is set forth below.

Article I. Use of worldwide combination/unitary method of apportionment

In conformity with the Church reservation, the proposed protocol makes Article 9(4) of the proposed treaty, which restricts the use of the worldwide combination/unitary method of apportioning income, inapplicable to state or local governments. The provisions of Article 9(4) would continue to apply, however, to the United States and United Kingdom governments.

Under the protocol, political subdivisions and local authorities of either country are free to use formula methods to apportion income, deductions and other items among related enterprises in determining income subject to their taxes, so long as such methods do not violate the proposed treaty's nondiscrimination provisions *(Article 24)*.

Article 9(4) of the proposed treaty would have limited the methods by which the United States, the United Kingdom, and political subdivisions and local authorities of each country could tax enterprises of the other country (or enterprises which are directly or indirectly controlled by enterprises of the other country). (This provision is not found in other U.S. tax treaties.) The proposed treaty would have provided that, in determining the tax liability of such an enterprise doing business within their respective jurisdictions, the United States, the United Kingdom and their political subdivisions and local authorities could not take into account the income, deductions, receipts or outgoings of a related enterprise of the other country, or of any third country. This provision of the proposed treaty was intended to apply to those states of the United States (principally California, Oregon, and Alaska) which, in determining the amount of income of a business operating within the state which is to be apportioned to that state for income tax purposes, require combined reporting of

all related business operations (including related business operations of affiliated U.S. and foreign corporations, whether or not doing business within the state). The national governments of the United Kingdom and the United States do not apportion income between jurisdictions under this method but rather allocate income between related enterprises under arm's-length principles. In addition, the political subdivisions and local authorities of the United Kingdom do not impose income taxes.

The proposed protocol modifies this provision by eliminating its applicability to political subdivisions and local authorities of the United States and the United Kingdom. This is in conformity with the reservation proposed by Senator Church and adopted by the [p. 6] Senate as part of its resolution of ratification of the proposed treaty. The provision would, however, continue to apply to the two national governments. (Conforming changes are made in Article 2 of the proposed treaty (*Taxes covered*) to reflect this narrowed scope.)

Moreover, the proposed treaty, like most other U.S. tax treaties, contains a provision (*Article 9(1)*) similar to that contained in the Internal Revenue Code (sec. 482) which recognizes the right of each county to make an allocation of income in the case of transactions between related persons, if an allocation is necessary to reflect the conditions and arrangements which would have been made between unrelated persons. The limitation in Article 9(4) applies only to cases where an allocation is made without regard to any application of the arm's-length standard. Of course, both countries may apply apportionment formulas, including formulas that take into account attributes of related entities, as a method of achieving an arm's-length price for a transaction between related entities. Moreover, apportionment formulas may be used as a method of apportioning income of related entities to the extent that it is established that they are not dealing on an arm's-length basis. The proposed treaty does not affect U.S. tax rules for allocating and apportioning income, deductions, and other items among related enterprises (Code sec. 482), nor is it applicable to the U.S. tax rules concerning the source of income and the deductions attributable thereto (Treas. Reg. § 1.861-8).

During last year's debate both in the Foreign Relations Committee and on the Senate floor, opponents of Article 9(4) argued that any prohibition of the right of states to use worldwide combination under the unitary tax system should be addressed legislatively rather than through the treaty process. Even some supporters of Article 9(4), while not questioning the propriety of the Article, indicated their preference for Congressional consideration through the legislative process of the issue. The Foreign Relations Committee notes that Section 303 of S. 983, the Interstate Taxation bill introduced by Senator Mathias, would accomplish for all nations what Article 9(4) of the U.S.-U.K. Tax Treaty sought to accomplish for the U.K.

The Committee urges the tax-writing Committees of the Congress — the Finance and the Ways and Means Committees — to hold hearings in the very near future on S. 983 in order to permit all sides of the issue to have their views known for the record. In addition, such legislation will give the Congress, which has the responsibility to resolve on the federal level inconsistent state taxation policies, the opportunity to take a position on the merits of the issue.

The Committee also notes both Senator Mathias' statement before the Committee in support of the Treaty and the Third Protocol and his view that the British "Parliament will ratify the U.S.-U.K. Treaty only if they perceive that we are serious about making progress on the Interstate Taxation bill . . ." The Committee wishes to make clear that it considers expeditious treatment of the Treaty by both the U.S. Senate and the U.K. Parliament to be critical in order to permit the benefits of the Treaty to flow to both sides.

* * *

[p. 15] IX. ADDITIONAL VIEWS OF SENATOR HOWARD BAKER

In reporting favorably the Third Protocol further amending the Tax Convention between the United States and the United Kingdom, the committee has recognized the importance of ratification of the Convention by both countries.

It is worth noting that the chances of ratification in timely fashion by the Parliament will be enhanced by evidence of Congressional intent to consider domestic legislation to regulate the authority of the several States and their local jurisdictions to tax foreign multinational corporations under a unitary method of taxation. The committee has information that an Early Day Motion was introduced on June 11, 1979, in the House of Commons by members of the governing Conservative Party. If approved, that Motion would instruct Her Majesty's Government to insure through appropriate arrangements that use of the unitary method of taxation on a worldwide combined reporting basis is prohibited.

As originally drafted and submitted to the Senate for advice and consent to ratification, the U.S.-U.K. Tax Convention would have prohibited under Article 9(4) the use of such methods of foreign corporate taxation by both countries and by several States. In adopting its reservation to Article 9(4) in June of 1978, the Senate appeared to reach a consensus that domestic legislation, as an alternative to international treaty language, is preferable in regulating that conduct of the States which may affect foreign commerce. The terms of the Third Protocol, negotiated by the previous government of the United Kingdom and the United States to accommodate the Senate's reservation, is silent, of necessity, on the proper limits of the States' power to tax British multinational corporations.

Under the unitary method of taxation on a worldwide combined reporting basis, any one of the States of this Union has the opportunity unilaterally to establish tax liability for local subsidiaries of foreign multinational corporations. Although Congress alone has the power, under the Constitution, to "regulate Commerce with Foreign Nations," the States may incorrectly interpret the Senate's reservation to Article 9(4), and the Third Protocol to this Convention, as an invitation to establish tax policies applicable to foreign source income which are inconsistent or incompatible with broad National tax policies.

In the landmark case of *Japan Line, Ltd.* v. *County of Los Angeles*, No. 77-1378, decided April 30, 1979, the U.S. Supreme Court held that a State of this Union may not tax the instrumentalities of foreign commerce if the tax "... creates a substantial risk of international multiple taxation, and ... prevents the Federal government from 'speaking with one voice when regulating commercial relations with foreign Governments.'" (Slip Opinion 16). There is no doubt [p. 16] that the unitary method of taxation on a worldwide combined reporting basis creates a substantial risk of multiple taxation of international operations. Almost by definition, that method prevents the Federal Government from "speaking with one voice" in commercial relations with foreign governments.

There is pending in the Senate legislation which would remedy the situation. As introduced by Senator Mathias, S. 983 would define the outer limits of power of a State to apportion foreign source income to operations and activities within its jurisdiction. As a practical matter, Senator Mathias' bill in Section 303 would assure the power of a State to tax that foreign source income that is properly allocable under Section 482 of the Internal Revenue Code. Upon enactment of the relevant portions of Senator Mathias' bill, the risk of international multiple taxation by a State of this Union will be diminished, and the United States will "speak with one voice" as required by the Constitution.

If Congress does not act promptly to conform the foreign source tax policies of the States to national tax policy, the repercussions abroad could be severely damaging to U.S. interests. The precedent of unitary taxation on a worldwide combined reporting basis cannot be established by this country without probable retaliation by scores of countries around the world whose ambition may extend to those profits of U.S. multinational corporations generated beyond their jurisdictional limits.

If Congress acts to resolve the uncertainty created by the reservation to Article 9(4) as reflected in the Third Protocol, the American people can reasonably expect timely consideration of this important Tax Convention by the House of Commons. That is an objective which all Senators must share.

HOWARD H. BAKER, JR.

* * *

[p. 23] LETTER OF SUBMITTAL

THE PRESIDENT,
The White House.

DEPARTMENT OF STATE,
Washington, April 3, 1979.

THE PRESIDENT: I have the honor to submit to you, with a view to its transmission to the Senate for advice and consent to ratification, the Third Protocol further amending the Convention between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains, signed at London on December 31, 1975, as amended by an exchange of notes dated April 13, 1976, and by Protocols signed at London on August 26, 1976 and March 31, 1977. The Third Protocol was signed at London on March 15, 1979.

The Senate gave advice and consent to ratification to the Convention, as amended, on June 27, 1978, with a reservation as to Article 9(4). Article 9(4) would have restricted the power of states of the United States to apply the unitary method of taxation to British multinational companies. The Senate's reservation stipulates that the provisions of Article 9(4) will not apply to any political subdivision or local authority of the United States.

The Third Protocol makes a number of changes to conform the language of the Convention to the Senate's reservation on Article 9(4). Execution of the Third Protocol by the United Kingdom and approval by the British House of Commons would confirm acceptance by the United Kingdom of the Senate's reservation with respect to Article 9(4) of the Convention.

The Third Protocol also modifies the definition of a "permanent establishment" in the case of activities carried on offshore in connection with the exploration and exploitation of the seabed and subsoil and their natural resources. Such activities are deemed to create a "permanent establishment" in a Contracting State if such activities were carried on in the State for at least 31 days in a 12 month period.

In addition, the Third Protocol provides a special limitation on the creditability by United States citizens or residents of the

United Kingdom petroleum revenue tax paid or accrued by them. This provision was included in the Third Protocol because of concern expressed during the Senate debate that the petroleum revenue tax (PRT) might be used by oil companies with North Sea operations to shelter oil related income from other countries. Under the provisions of the Third Protocol, the creditability of the PRF is limited by an amount determined with reference to United Kingdom source oil income.

[p. 24] The Third Protocol also makes a number of technical and clarifying changes to the provisions of the Convention dealing with the United States excise tax on insurance premiums, the taxation of remuneration for government service, dividends from dual resident corporations, and the period of time during which refunds relating to taxes paid in previous periods may be applied for.

A technical memorandum explaining in detail the provisions of the Third Protocol is being prepared by the Department of the Treasury and will be submitted to the Senate Foreign Relation Committee.

The Department of the Treasury, with the cooperation of the Department of State, was primarily responsible for the negotiation of the Third Protocol. It has the approval of both Departments.

Respectfully submitted.

CYRUS VANCE.

[p. 25] THIRD PROTOCOL FURTHER AMENDING THE CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND CAPITAL GAINS, SIGNED AT LONDON ON 31 DECEMBER 1975.

The Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland;

Desiring to conclude a third Protocol to amend the Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital Gains, signed at London on 31 December 1975, as amended by Notes exchanged at London on 13 April 1976 and by Protocols signed at London on 26 August 1976 and 31 March 1977 (hereinafter referred to as "the Convention");

Have agreed as follows:

ARTICLE I

(1) Paragraph (2) of Article 2 (Taxes covered) shall be deleted and replaced by the following:

"(2) The existing taxes to which this Convention shall apply are:

(*a*) in the case of the United States, the Federal income taxes imposed by the Internal Revenue Code and the tax on insurance premiums paid to foreign insurers; but (except as provided in paragraph (6) of Article 10 (Dividends)) excluding the accumulated earnings tax and the personal holding tax. The foregoing taxes covered are hereinafter referred to as "United States tax";

(*b*) in the case of the United Kingdom, the income tax, the capital gains tax, the corporation tax and the petroleum

revenue tax. The foregoing taxes covered are hereinafter referred to as "United Kingdom tax"."

(2) Paragraph (3) or Article 2 (Taxes covered) shall be deleted and replaced by the following:

(3) This Convention shall also apply to any identical or substantially similar taxes which are imposed by a Contracting State after the date of signature of this Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any changes which have been made in their respective taxation laws."

(3) Paragraph (4) of Article 9 (Associated enterprises) shall be deleted and replaced by the following:

[p. 26] "(4) Except as specifically provided in this Article:

(*a*) where an enterprise doing business in one Contracting State:

(i) is a resident of the other Contracting State; or

(ii) is controlled, directly or indirectly, by an enterprise which is a resident of the other Contracting State; and

(*b*) where the enterprise which is a resident of the other Contracting State is a corporation, such corporation is neither:

(i) a controlled foreign corporation within the meaning of section 957 of the United States Internal Revenue Code of 1954 (as it may be amended from time to time without changing the principle thereof); nor

(ii) created or organised under the laws of the first-mentioned State or of any third State or controlled, directly or indirectly, by a corporation which is a resident of any third State;

then, in determining the tax liability of the first-mentioned enterprise in the State in which it does business, such State shall not take into account the income, deductions, receipts or outgoings of a related enterprise which is a resident of the other Contracting State or of an enterprise of any third State

which is related to the enterprise of the other Contracting State, except that this prohibition shall not apply where the first-mentioned enterprise is a resident of the first-mentioned Contracting State, to the extent that it owns, directly or indirectly, the capital of the related enterprise."

* * *

[p. 33] TECHNICAL EXPLANATION OF THE THIRD PROTOCOL SIGNED AT LONDON ON MARCH 15, 1979 (THE "THIRD PROTOCOL" OR THE "PROTOCOL") FURTHER AMENDING THE CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND CAPITAL GAINS SIGNED AT LONDON, ON DECEMBER 31, 1975, AS AMENDED BY THE NOTES EXCHANGED AT LONDON ON APRIL 13, 1976, AND THE PROTOCOLS SIGNED AT LONDON ON AUGUST 25, 1976 AND MARCH 31, 1977 (THE CONVENTION AS AMENDED BY THE NOTES AND THE TWO PROTOCOLS BEING REFERRED TO AS THE "CONVENTION").

The Third Protocol contains seven articles which modify Articles 2 (Taxes covered), 7 (Business profits), 9 (Associated enterprises), 10 (Dividends), 19 (Government service), 23 (Elimination of double taxation), and 28 (Entry into force) of the Convention. In addition, Article VI of the Protocol adds a new Article 27A (Offshore activities) to the Convention. Set forth below is an explanation of each article of the Protocol.

ARTICLE I

Article I contains three paragraphs serving to conform the text of the Convention to the United States Senate's reservation which was made a part of its June 27, 1978 resolution of advice and consent to ratification. The references to income taxes imposed by political subdivisions or local authorities are deleted from

paragraphs (2) and (3) of Article 2 (Taxes covered) and from paragraph (4) of Article 9 (Associated enterprises). The other provisions of those paragraphs are restated. Taxes imposed by political subdivisions and local authorities remain subject to the provisions of Article 24 (Non-discrimination) of the Convention, by reason of paragraph (4) of Article 2 (Taxes covered).

* * *

[p. 43] APPENDIX C

WRITTEN RESPONSES BY WITNESSES TO QUESTIONS BY SENATORS AND COMMITTEE STAFF

DEPARTMENT OF THE TREASURY,
Washington, D.C., June 8, 1979.

HON. FRANK CHURCH,
Chairman, Committee on Foreign Relations,
U.S. Senate
Washington, D.C.

DEAR MR. CHAIRMAN: To follow-up my testimony at the June 6 hearings concerning the six tax conventions or protocols involving the United Kingdom, France, Hungary and Korea, I want to assure you that Article I of the Third Protocol of the proposed US-UK Income Tax Treaty gives full effect to the Senate's reservation on Article 9(4) of that treaty. Let me also assure you that there is no similar state tax issue in any of the other five treaties which were considered by the Committee yesterday.

Again let me emphasize our view that each of these treaties is important to the United States and that their prompt approval is desirable.

I am also enclosing answers to the written questions submitted to me by your staff at the hearings as well as copies of my answers to questions from Senator Helms and Senator Javits.

Sincerely,

DONALD C. LUBICK,
Assistant Secretary (Tax Policy).

Enclosures.

QUESTIONS FOR ASSISTANT SECRETARY FOR TAX POLICY
DONALD C. LUBRICK

* * *

[p. 45] *Question 5.* The U.S. Treasury, in 1977, finalized a "model convention" for international tax treaties, could you please explain the status of this model and in particular, any changes that have been made to it?

Answer. For many years the Treasury had used an informal "model" as a basis for negotiations. This model evolved and changed as the negotiators gained experience with it. In 1976 a decision was made to publish the U.S. model. Following the 1977 publication of the revised OECD Model Convention, the Treasury revised its model to conform it to the OECD Model, where possible, and the revised model was published in May of 1977.

The model is sent to potential treaty partners prior to the commencement of negotiations, and it normally serves as the discussion draft during the first round of negotiations. Many changes are made in the model during negotiations to reflect particular problems which arise in attempting to mesh two tax systems. Changes may be made to reflect the needs of the other country. For example, where negotiations are with a developing country, many of the model provisions (designed for treaties between two developed countries) are inappropriate. The U.S. negotiators are generally quite flexible in modifying the model for treaties with developing countries. These changes occur most frequently in the provisions dealing with permanent establishments or the taxation of personal service income, in which cases a somewhat lesser degree of economic contact or penetration is required for the host county to be able to tax the income of a resident of the other country. Similarly, with the taxation of dividends, interest, and royalties, less of a reduction in withholding tax rates is generally required of developing countries. The U.S. interest in these cases is to avoid rates which are so high as to generate excess foreign tax credits for U.S. income recipients.

Questions 6 and 7. In the third protocol proposed to the U.S.-U.K. Income Tax Treaty, the definition of permanent establishment has been changed. Please explain the basis of this change. Were the affected U.S. drilling companies contacted

concerning the proposed change? If they were contacted, please give the details of when, by whom, and what resulted from such contact. Why was the permanent establishment definition selected as the item to be changed in the tax area?

Answer. In our discussions with the British subsequent to the Senate reservation on Article 9(4) of the proposed treaty, the United Kingdom specifically requested the inclusion in the protocol of a provision clarifying their taxing rights with respect to exploration and exploitation connected activities. This requested clarification was not unusual in light of the original negotiations in 1975 over the permanent [p. 46] establishment definition. In those negotiations, the United States agreed to delete from the twelve month permanent establishment exclusion contained in subparagraph (2)(f) of the proposed treaty any reference to "an installation or drilling rig or ship used for the exploration or development of natural resources" as a result of the British insistence that there be no limitation on their right to tax such activities. This deletion left the application of the permanent establishment definition to these activities somewhat uncertain, although as the United Kingdom authorities believe, a strong argument exists that these activities could be taxed even without the clarification of the new protocol.

We agreed to the inclusion of this provision in the Third Protocol because it was reasonable to expect the British to request some additional concession for the loss of the benefits of Article 9(4); because the terms of the provisions were reasonable in light of our own statutory tax policy (we would generally tax these kinds of activities conducted in the United States, even if they were of a shorter duration than 30 days); and because it could be viewed as little more than a clarification of a reasonable interpretation taken by the British of their taxing rights under the proposed treaty without the the protocol provision.

The drilling industry was clearly aware of the precise terms of the protocol provision at least one month prior to the signing of the Protocol on March 15, 1979. On February 16, 1979, Mr. Arnold W. Bramlett, Chairman of the Accounting and Taxation Committee of the International Association of Drilling Contractors (IADC), wrote to the International Tax Counsel, Mr. II.

David Rosenbloom, expressing general concern over the provision. Subsequently, there were telephone conversations between Mr. Rosenbloom and Mr. Bramlett in which the Treasury sought specific information as to the nature of the activities and the harm which was alleged would occur. These requests were confirmed in a letter from Mr. Rosenbloom to Mr. Bramlett on March 5, 1979, still 10 days before the Protocol was signed. To date, the Treasury has not received from the IADC, or any of its members, specific information detailing any specific adverse effects of the protocol provision.

EXHIBIT 37H

INTERNATIONAL TAX TREATIES

HEARING
BEFORE THE
COMMITTEE ON FOREIGN RELATIONS

UNITED STATES SENATE

NINETY-SIXTH CONGRESS

FIRST SESSION
ON

SIX INTERNATIONAL TAX TREATIES AND
PROTOCOLS

JUNE 6, 1979

Printed for the use of the Committee on Foreign Relations

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1979

Third Protocol to the United States-United Kingdom Income Tax Treaty

Question 13. Would you please summarize the British reaction to the reservation included in the Senate advice and consent to ratification last June 27, 1978, concerning Article 9(4).

Answer. The British tax authorities were unhappy with the Senate reservation concerning Article 9(4). They hoped that a modified version of Article 9(4) might be included in the treaty. When it became clear that there was no possibility of a modification which would be acceptable to all parties, they reluctantly agreed to seek Parliamentary approval of the treaty with the deletion of Article 9(4) but only after the Third Protocol is approved by the Senate. The British authorities view some of the provisions of the Third Protocol (particularly the North Sea permanent establishment rules) as a concession for the deletion of Article 9(4). We recently reconfirmed with the British their willingness to go forward with the treaty if the protocol is approved by the Senate.

Very strong objection has been raised by the U.K. business community to the deletion of Article 9(4). Many business and industrial groups in the U.K. have urged Parliament not to reapprove the treaty in the absence of the Article 9(4) provision.

The strength of these objections was confirmed by testimony at the June 6 hearings to the effect that there is a view among some Conservative Members of Parliament that the treaty should not be approved unless some solution can be found to the state taxation problem, albeit outside the treaty framework.

* * *

I. Scope of the Treaty

The first two articles of both the U.S. Model and the OECD Model define the personal scope of the treaty and the taxes covered. The differences in the scope of the two models are discussed below.

1. *Personal scope.* — In delimiting the personal scope of the treaty, the most significant departure in the U.S. Model from the OECD Model is the reservation to each Contracting State of the

right to tax its own residents and nationals as if the treaty did not come into effect. This provision overrides any other provision that would otherwise limit the authority of a Contracting State to apply its internal tax law to its citizens or residents. The only exceptions to this rule relate to provisions that are clearly intended to limit the authority of a Contracting State to tax its citizens or residents. The provisions of the treaty relating to the foreign tax credit, non-discrimination and the mutual agreement procedure are examples of those exceptions. The reason for this provision, known as the "saving clause", is that the United States views treaties as affecting a Contracting State's right to tax residents and citizens of the other Contracting State, and not as affecting its right to tax its own residents and citizens.

Under the saving clause, the United States retains it statutory right to tax its citizens and residents on worldwide income. The United States also retains the right to tax a former citizen on U.S. source income for a 10-year period if the former citizen renounced citizenship to avoid U.S. taxes.

In addition to this reservation of the right of each Contracting State to tax its own citizens and residents, the U.S. Model also clarifies that some of the treaty provisions apply to persons that are not residents of either of the Contracting States. The OECD Model makes this clarification in later provisions of the treaty.

2. *Taxes covered.* — With respect to taxes covered by the treaty, the U.S. Model contains two differences from the OECD Model. A minor difference is that the U.S. Model focuses on a specific list of taxes covered and does not contain a general discussion of those taxes. A more significant difference is that, except for purposes of the Non-Discrimination Article, income and capital taxes imposed by local subdivisions of the United States are not covered by the treaty. These local U.S. taxes are not covered because it is unlikely that the United States would consent to the ratification of any treaty provision that restricted the rights of the various states to impose their own taxes.

* * *

EXHIBIT 371

S. Hrg. 9
REVIEW OF UNITARY METHOD OF TAXATION

HEARING
BEFORE THE
SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT
OF THE COMMITTEE ON FINANCE

UNITED STATES SENATE
NINETY-NINTH CONGRESS

SECOND SESSION
ON

S. 1113 and S. 1974

SEPTEMBER 29, 1986

Printed for the use of the Committee on Finance

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For Release Upon Delivery
Expected at 9:30 a.m. EST
Monday, September 29, 1986

STATEMENT OF THE HONORABLE J. ROGER MENTZ ASSISTANT SECRETARY (TAX POLICY) DEPARTMENT OF TREASURY TO THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT OF THE SENATE FINANCE COMMITTEE UNITED STATES SENATE

Mr. Chairman and Members of the Committee:

Thank you for this opportunity to present the views of the Department of the Treasury on S. 1974, a bill introduced by Senator Pete Wilson that addresses state taxation of the worldwide income of corporations and their affiliates. In general, S. 1974 would prohibit states from levying corporate income taxes on a worldwide unitary basis, would require states to tax foreign source dividends in an equitable manner, and would provide additional federal assistance to the states for the administration and enforcement of their corporate income taxes. As you know, this legislation was drafted by the Treasury Department at the express direction of the President and was introduced last December with the full support of the Administration. Identical legislation was introduced in the House of Representatives as H.R. 3980.

I am pleased to report that, since the introduction of the legislation, Idaho, New Hampshire, Utah and, on September 5, California, have enacted "water's edge" legislation. The Administration applauds these states' actions. These state legislative developments go a long way toward resolving the difficult unitary tax issue. Moreover, they illustrate the successful operation of the Federal system. These and the other states that have moved away from the worldwide unitary tax system in recent years recognize that their interest, and the national interest, lies in a single,

coherent approach to taxing international income that minimizes tax-related impediments to international flows of investment capital.

We have not, however, reached the end of the road with respect to this issue. Though the economic impact is not great, three states (Alaska, Montana, and North Dakota) continue to impose tax on a worldwide unitary basis. As I will discuss below, we also have concerns regarding elements of the California legislation. We believe, however, that such significant progress has been made that restrictive Federal legislation is not warranted at this time. Rather, we believe that Congressional action on S. 1974 should be deferred until the remaining worldwide unitary states have a full opportunity to act, California has an opportunity to consider and respond to comments on its recently enacted legislation, and we have an opportunity to evaluate the actual operation of water's edge legislation passed by the several states when fully in effect.

We also do not believe that a treaty resolution of the unitary issue is necessary or appropriate at this time. Because a treaty would offer relief from worldwide unitary tax to foreign based multinationals while not addressing the inclusion of foreign dividends to domestic multinationals, a treaty resolution does not by itself satisfy the principle of ensuring competitive balance among similarly situated businesses. We therefore view a treaty approach to the issue as the least desirable of possible alternatives.

While we do not believe that restrictive federal legislation is called for at this time, the Administration has advocated broader federal support of state tax collection activities. States have moved away from the worldwide unitary method in part in reliance on the Administration's representations in this regard. To the extent possible without legislation, the Administration has already moved to provide greater assistance to the states. We continue to be committed to providing such federal support and believe that the portions of S. 1974 that are directed to that objective should be enacted at the earliest practicable time.

The progress made on this difficult issue is a tribute to the wisdom of President Reagan's decision in 1983 to seek a cooperative solution by convening a Worldwide Unitary Taxation Working Group, consisting of representatives from states, business and the Federal government, to address the issue. It is also a tribute to the leadership evidenced by the state officials and leaders of domestic and foreign-controlled multinationals that have together forged compromises in states across the country. We expect that these participants will continue to demonstrate the same leadership as we attempt to address the remaining concerns relating to the worldwide unitary tax issue.

In the remainder of my testimony I will discuss the background of the worldwide unitary issue, the proposed Federal solution, and concerns raised by the California legislation.

I. BACKGROUND

A. Separate Accounting Versus Worldwide Unitary Combination

The operation of a business enterprise across state or national boundaries requires each jurisdiction to determine what portion of the enterprise's income it will tax. The objective of each taxing jurisdiction should be to attribute to itself an amount of the income of the multijurisdictional enterprise that is appropriate in relation to the economic activity conducted in that jurisdiction. Failure of any of the taxing jurisdictions to assign the income to the respective jurisdictions of operation under a consistent accounting method may result in over-taxation . . . .

* * *

In response to the Working Group recommendations four states, Florida, Indiana, Oregon and Colorado, acted promptly to adopt acceptable water's edge legislation. Other states, however, moved more slowly. In particular, in 1985 the California legislature considered, but failed to adopt, legislation that would have limited that state's use of the worldwide unitary system of taxation.

Continued inaction by these states on the unitary issue after the Working Group deliberations resulted in even stronger foreign protests. Most seriously, in July 1985 the U.K. Parliament unanimously adopted Section 54, in its 1985 Finance Bill. This

provision permits the U.K. government to deny, on a unilateral and retroactive basis, the valuable Advance Corporation Tax refund benefit granted by the U.S.-U.K. bilateral tax treaty to U.S. corporations that own British subsidiaries. Although the U.K. has not yet invoked Section 54, the very existence of that provision and the possibility of its retroactive implementation has had a detrimental impact on the willingness of U.S. companies to repatriate earnings from their U.K. subsidiaries in accordance with the treaty provision as well as a detrimental impact on commercial relations between the United States and the United Kingdom.*

* * *

*The Treasury Department has serious concerns regarding Section 54. We believe that its existence is inconsistent with the U.S.-U.K. bilateral income tax treaty to the extent its threatened use causes U.S. taxpayers to refrain from claiming benefits under the treaty. Its actual implementation would be a clear violation of the treaty.

EXHIBIT 40GG

Income Tax Treaty — United Kingdom

United Kingdom

Income tax treaty

Signed 12/31/75; entered into force 4/25/80; operative, generally, 1/1/75 (4/1/73 or 4/6/75) for refunds of tax on certain dividends paid to U.S.). Modified by notes exchanged on 4/13/76; protocol signed 8/26/76; second protocol signed 3/31/77; and third protocol signed 3/15/79; all entered into force and operative as above.

Article 1 — Personal Scope

(1) Except as specifically provided herein, this Convention is applicable to persons who are residents of one or both of the Contracting States.

(2) A corporation which is both a resident of the United Kingdom within the meaning of paragraph (1)(a)(ii) of Article 4 (Fiscal Residence), and a resident of the United States within the meaning of paragraph (1)(b)(ii) of Article 4 shall not be entitled to claim any relief or exemption from tax provided by this Convention except that such corporation may claim the benefits of paragraph (2) of Article 8 (Shipping and Air Transport), of Article 23 (Elimination of Double Taxation) with respect to paragraph (1)(c) thereof and the petroleum revenue tax referred to in paragraph (2)(b) of Article 2 (Taxes Covered), of Article 24 (Non-Discrimination) and of Article 28 (Entry into Force) and the provisions of paragraph (7) of Article 11 (Interest) shall apply to it.

(3) Notwithstanding any provision of this Convention except paragraph (4) of this Article, a Contracting State may tax its residents (as determined under Article 4 (Fiscal Residence)) and its nationals as if this Convention had not come into effect.

(4) Nothing in paragraph (3) of this Article shall affect the application by a Contracting State of:

(a) paragraph (4) of Article 4 (Fiscal Residence), paragraph (2) of Article 8 (Shipping and Air Transport), and

Articles (9) (Associated Enterprises), 23 (Elimination of Double Taxation), 24 (Non-Discrimination) and 25 (Mutual Agreement Procedure); and

(b) Articles 19 (Government Service), 20 (Teachers), 21 (Students and Trainees), and 27 (Effect on Diplomatic and Consular Officials and Domestic Laws), with respect to individuals who are neither nationals of, nor have immigrant status in, that State.

Article 2 — Taxes Covered

(1) This Convention shall apply to taxes on income imposed by each Contracting State and as hereinafter provided to taxes imposed by its political subdivisions or local authorities.

(2) The existing taxes to which this Convention shall apply are:

(a) in the case of the United States, the Federal income taxes imposed by the Internal Revenue Code and the tax on insurance premiums paid to foreign insurers; but (except as provided in paragraph (6) of Article 10 (Dividends)) excluding the accumulated earnings tax and the personal holding tax. The foregoing taxes covered are hereinafter referred to as "United States tax";

(b) in the case of the United Kingdom, the income tax, the capital gains tax, the corporation tax and the petroleum revenue tax. The foregoing taxes covered are hereinafter referred to as "United Kingdom tax"."

(3) This Convention shall also apply to any identical or substantially similar taxes which are imposed by a Contracting State after the date of signature of this Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any changes which have been made in their respective taxation laws.

(4) For the purposes of Article 24 (Non-discrimination), this Convention shall also apply to taxes of every kind and description imposed by each Contracting State, or by its political subdivisions or local authorities.

Article 3 — General Definitions

(1) In this Convention, unless the context otherwise requires:

(a) the term "corporation" means a United States corporation, a United Kingdom corporation, or any body corporate or other entity of a third State which is treated as a body corporate for tax purposes by both Contracting States;

(b) the term "United States corporation" means:

(i) a corporation (or any unincorporated entity treated as a corporation for United States tax purposes) which is created or organized under the laws of the United States or any state thereof or the District of Columbia; and

(ii) the term "United Kingdom corporation" means any body corporate or unincorporated association created or organized under the laws of the United Kingdom, but does not include a partnership, a local authority, or a local authority association;

(c) the term "person" includes an individual, a corporation, a partnership, an estate, a trust and any other body of persons;

(d) the term "enterprise of a Contracting State" means an industrial or commercial undertaking carried on by a resident of a Contracting State;

(e) the term "international traffic" means any transport by a ship or aircraft operated by an enterprise of a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State;

(f) the term "competent authority" means:

(i) in the case of the United States, the Secretary of the Treasury or his delegate, and

(ii) in the case of the United Kingdom, the Commissioners of Inland Revenue or their authorized representatives;

(g) the term "United States" means:

(i) the United States of America; and

(ii) when used in a geographical sense, the States thereof and the District of Columbia. Such term also includes: (aa) the territorial sea thereof, and (bb) the seabed and subsoil of the submarine areas adjacent to the coast thereof, but beyond the territorial sea, over which the United States exercises sovereign rights, in accordance with international law, for the purpose of exploration for and exploitation of the natural resources of such areas, but only to the extent that the person, property, or activity to which the Convention is being applied is connected with such exploration or exploitation;

(h)

(i) the term "United Kingdom" means Great Britain and Northern Ireland, including any area outside the territorial sea of the United Kingdom which in accordance with international law has been or may hereafter be designated, under the laws of the United Kingdom concerning the Continental Shelf, as an area within which the rights of the United Kingdom with respect to the seabed and subsoil and their natural resources may be exercised;

(i) the term "Contracting State" means the United States or the United Kingdom, as the context requires;

(j) the term "nationals" means:

(i) in relation to the United Kingdom, all citizens of the United Kingdom and Colonies, British subjects under Sections 2, 13(1) or 16 of the British Nationality Act 1948, and British subjects by virtue of Section 1 of the British Nationality Act 1965, provided they are partial within the meaning of the Immigration Act 1971, so far as these provisions are in force on the date of entry into force of this Convention or have been modified only in minor respects so as not to affect their general character;

(ii) in relation to the United States, United States citizens.

(2) As regards the application of this Convention by a Contracting State any term not otherwise defined shall, unless the context otherwise requires and subject to the provisions of Article 25 (Mutual Agreement Procedure), have the meaning which it has under the laws of that Contracting State relating to the taxes which are the subject of this Convention.

Article 4 — Fiscal Residence

(1) For the purposes of this Convention:

(a) the term "resident of the United Kingdom" means:

(i) any person, other than a corporation, resident in the United Kingdom for the purposes of United Kingdom tax; but in the case of a partnership, estate, or trust, only to the extent that the income derived by such partnership, estate, or trust is subject to United Kingdom tax as the income of a resident, either in its hands or in the hands of its partners or beneficiaries; and

(ii) a corporation whose business is managed and controlled in the United Kingdom;

(b) the term "resident of the United States" means:

(i) any person, other than a corporation, resident in the United States for the purposes of United States tax; but in the case of a partnership, estate, or trust, only to the extent that the income derived by such partnership, estate, or trust is subject to United States tax as the income of a resident, either in its hands or in the hands of its partners or beneficiaries; and

(ii) a United States corporation.

(2) Where by reason of the provisions of paragraph (1) an individual is a resident of both Contracting States, then the individual's tax status shall be determined as follows:

(a) the individual shall be deemed to be a resident of the Contracting State in which he has a permanent home available to him. If the individual has a permanent home available to him in both Contracting States or in either of the Contracting States, he shall be deemed to be a resident of the Contracting State with which his personal and economic relations are closest (centre of vital interests);

(b) If the Contracting State in which the individual's centre of vital interests is located cannot be determined, he shall be deemed to be a resident of that Contracting State in which he has an habitual abode;

(c) If the individual has an habitual abode in both Contracting States or in neither of them, he shall be deemed to be a resident of the Contracting State of which he is a national; and

(d) If the individual is a national of both Contracting States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

(3) Where by reason of the provisions of paragraph (1) an estate or trust may be a resident of both Contracting States, the competent authorities of the Contracting States may settle the question of residence by mutual agreement.

(4) A marriage before 1 January 1974 between a woman who is a United States national and a man domiciled within the United Kingdom shall be deemed to have taken place on 1 January 1974 for the purpose of determining her domicile on or after 6 April 1976 for United Kingdom tax purposes.

(5) Where under any provison of this Convention income arising in one of the Contracting States is relieved from tax in that Contracting State and, under the law in force in the other Contracting State a person, in respect of the said income, is subject to tax by reference to the amount thereof which is remittted to or received in that other Contracting State and not by reference to the full amount thereof, then the relief to be allowed under this Convention in the first-mentioned Contracting State shall apply only to so much of the income as is remitted to or received in the other Contracting State.

Article 5 — Permanent Establishment

(1) For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

(2) The term "permanent establishment" shall include especially:

(a) a branch;

(b) an office;

(c) a factory;

(d) a workshop;

(e) a mine, oil or gas well, quarry, or other place of extraction of natural resources; and

(f) a building or construction or installation project which exists for more than 12 months.

(3) Notwithstanding the provisions of the preceding paragraphs, the term "permanent establishment" shall be deemed not to include a fixed place of business used solely for one or more of the following activities:

(a) the storage, display, or delivery of goods or merchandise belonging to the enterprise;

(b) the maintenance of a stock of goods or merchandise belonging to the enterprise for the purpose of storage, display or delivery;

(c) the maintenance of a stock of goods or merchandise belonging to the enterprise for the purpose of processing by another person;

(d) the maintenance of a fixed place of business for the purpose of purchasing goods or merchandise, or for collecting information, for the enterprise;

(e) the maintenance of a fixed place of business for the purpose of advertising, for the supply of information, for scientific research, or for similar activities which have a preparatory or auxiliary character, for the enterprise; or

(f) a building or construction or installation project which does not exist for more than 12 months.

(4) A person acting in a Contracting State on behalf of an enterprise of the other Contracting State — other than an agent of an independent status to whom paragraph (5) applies — shall be deemed to have a permanent establishment of the enterprise in the first-mentioned State if such person has, and habitually

exercises in that State, an authority to conclude contracts in the name of the enterprise, unless the contracts are confined to the activities described in paragraph (3) of this Article.

(5) An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent or any other agent of independent status, where such persons are acting in the ordinary course of their business.

(6) The fact that a corporation which is a resident of a Contracting State controls or is controlled by a corporation which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either corporation a permanent establishment of the other.

Article 6 — Income From Immovable Property (Real Property)

(1) Income from immovable property (real property), including income from agriculture or forestry, may be taxed in the Contracting State in which such property is situated.

(2) The term "immovable property" shall be defined in accordance with the law of the Contracting State in which the property in question is situated. The term shall in any case include usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats and aircraft shall not be regarded as immovable property.

(3) The provisions of paragraph (1) shall apply to income derived from the direct use, letting, or use in any other form of immovable property.

Article 7 — Business Profits

(1) The business profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carried on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the business profits of the enterprise may be taxed in that other State but only so much of them as is attributable to that permanent establishment.

(2) Subject to the provisions of paragraph (3), where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

(3) In the determination of the profits of a permanent establishment, there shall be allowed as deductions those expenses which are incurred for the purposes of the permanent establishment, including a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses incurred for the purposes of the enterprise as a whole (or the part thereof which includes the permanent establishment), whether incurred in the State in which the permanent establishment is situated or elsewhere.

(4) No business profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

(5) For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

(6) Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

(6A) The United States tax on insurance premiums paid to foreign insurers shall not be imposed on insurance on reinsurance premiums which are the receipts of a business of insurance carried on by an enterprise of the United Kingdom whether or not

that business is carried on through a permanent establishment in the United States.

(7) For the purposes of this Convention, "business profits" includes, but is not limited to, income derived from manufacturing, mercantile, banking, insurance, agricultural, fishing or mining activities, the operation of ships or aircraft, the furnishing of services, the rental of tangible personal (movable) property, and the rental or licensing of cinematographic films or films or tapes used for radio or television broadcasting or from copyrights thereof. Such term also includes any other income effectively connected with a permanent establishment which the recipient, being a resident of one of the Contracting States, has in the other Contracting State. Such term does not include the performance of personal services by an individual either as an employee or in an independent capacity.

Article 8 — Shipping and Air Transport

(1) Profits derived by an enterprise of a Contracting State from the operation of ships or aircraft in international traffic shall be taxable only in that State.

(2) Notwithstanding any other provision of this Convention, profits which a national of the United States not resident in the United Kingdom or a United States corporation derives from operating ships documented or aircraft registered under the laws of the United States shall be exempt from United Kingdom tax.

(3) For the purpose of this Article, profits from the operation of ships or aircraft include profits derived from the rental on a bareboat basis of ships or aircraft if such rental income is incidental to other income described in paragraph (1) of this Article.

(4) Notwithstanding the provisions of Article 7 (Business Profits), profits of an enterprise of a Contracting State from the use, maintenance or rental of containers (including trailers and related equipment for the transport of containers) used for the transport of goods or merchandise shall be taxable only in that State, except where such containers are used for the transport of

goods or merchandise solely between places within the other Contracting State.

(5) The provisions of this Article shall apply also to profits derived by an enterprise of a Contracting State from participation in a pool, a joint business or an international operating agency.

(6) Gains derived by an enterprise of a Contracting State from the alienation of ships, aircraft or containers owned and operated by the enterprise, the income from which is taxable only in that State, shall be taxed only in that State.

Article 9 — Associated Enterprises

(1) Where an enterprise of a Contracting State is related to another enterprise and conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would have been made between independent enterprises, then any income, deductions, receipts, or outgoings which would, but for those conditions, have been attributed to one of the enterprises but by reason of those conditions have not been so attributed, may be taken into account in computing the profits or losses of that enterprise and taxed accordingly.

(2) Where any income, deductions, receipts, or outgoings which have been taken into account in one Contracting State in computing the profits or losses of an enterprise are also taken into account in the other Contracting State in computing the profits and losses of a related enterprise in accordance with paragraph (1) of this Article, then the first-mentioned State shall make such adjustment as may be appropriate to the amount of tax charged on those profits in that State.

(3) If one Contracting State disagrees with the amount of any income, deductions, receipts, or outgoings, taken into account in computing profits or losses in the other in accordance with paragraph (1), the two Contracting States shall endeavor to reach agreement in accordance with the procedure in Article 25 (Mutual Agreement Procedure).

(4) Except as specifically provided in this Article:

(a) where an enterprise doing business in one Contracting State:

(i) is a resident of the other Contracting State; or

(ii) is controlled, directly or indirectly, by an enterprise which is a resident of the other Contracting State; and

(b) where the enterprise which is a resident of the other Contracting State is a corporation, such corporation is neither:

(i) a controlled foreign corporation within the meaning of section 957 of the United States Internal Revenue Code of 1954 (as it may be amended from time to time without changing the principle thereof); nor

(ii) created or organised under the laws of the first-mentioned State or of any third State or controlled, directly or indirectly, by a corporation which is a resident of any third State;

then, in determining the tax liability of the first-mentioned enterprise in the State in which it does business, such State shall not take into account the income, deductions, receipts or outgoings of a related enterprise which is a resident of the other Contracting State or of an enterprise of any third State which is related to the enterprise of the other Contracting State, except that this prohibition shall not apply where the first-mentioned enterprise is a resident of the first-mentioned Contracting State, to the extent that it owns, directly or indirectly, the capital of the related enterprise."

(5) For the purposes of this Convention, an enterprise is related to another enterprise if either enterprise directly or indirectly controls the other, or if any third person or persons (related to each other or acting together) control both.

Article 10 — Dividends

(1) Dividends derived from a corporation which is a resident of a Contracting State by a resident of the other Contracting State may be taxed in the other Contracting State. However, such

dividends may be taxed in the Contracting State of which the corporation paying the dividends is a resident, but if the beneficial owner is a resident of the other Contracting State, the tax so charged shall not exceed 15 per cent of the gross amount of the dividends.

(2) As long as an individual resident in the United Kingdom is entitled under United Kingdom law to a tax credit in respect of dividends paid by a corporation which is resident in the United Kingdom, paragraph (1) of this Article shall not apply. In these circumstances, dividends derived from a corporation which is a resident of a Contracting State by a resident of the other Contracting State may be taxed in the other Contracting State. However, such dividends may be taxed in the Contracting State of which the corporation paying the dividends is a resident, but if the beneficial owner is a resident of the other Contracting State, the tax so charged shall not exceed the tax provided in sub-paragraphs (a) and (b) below:

(a) In the case of dividends paid by a corporation which is a resident of the United Kingdom:

(i) to a United States corporation which either alone or together with one or more associated corporations controls, directly or indirectly, at least 10 per cent of the voting stock of the corporation which is a resident of the United Kingdom paying the dividend, the United States corporation shall be entitled to a payment from the United Kingdom of a tax credit equal to one-half of the tax credit to which an individual resident in the United Kingdom would have been entitled had he received the dividend, subject to the deduction withheld from such payment and according to the laws of the United Kingdom of an amount not exceeding 5 per cent of the aggregate of the amount of value of the dividend and the amount of the tax credit paid to such corporation;

(ii) in all other cases, the resident of the United States to whom such dividend is paid shall be entitled to a payment from the United Kingdom of the tax credit to which an individual resident in the United Kingdom would have been entitled had he received the dividend, subject to the deduc-

tion withheld from such payment and according to the laws of the United Kingdom of an amount not exceeding 15 per cent of the aggregate of the amount or value of the dividend and the amount of the tax credit paid to such resident;

(iii) the aggregate of the amount or value of the dividend and the amount of the tax credit referred to in sub-paragraphs (a)(i) and (ii) of this paragraph paid by the United Kingdom to the United States corporation or other resident (without reduction for the 5 or 15 per cent deduction, as the case may be, by the United Kingdom) shall be treated as a dividend for United States tax credit purposes.

(b) In the case of dividends paid by a United States corporation:

(i) to a corporation which is a resident of the United Kingdom and controls, directly or indirectly, at least 10 per cent of the voting stock of the United States corporation paying such dividend, the tax charged by the United States shall not exceed 5 per cent of the gross amount of the dividend;

(ii) in all other cases, the tax charged by the United States on payment of a dividend to a resident of the United Kingdom shall not exceed 15 per cent of the gross amount of the dividend.

For the purposes of this paragraph, two corporations shall be deemed to be associated if one controls directly or indirectly more than 50 per cent of the voting power in the other corporation, or a third corporation controls more than 50 per cent of the voting power in both of them.

(3) The term "dividends" for United Kingdom tax purposes includes any item which under the law of the United Kingdom is treated as a distribution and for United States tax purposes includes any item which under the law of the United States is treated as a distribution out of earnings and profits.

(4) Paragraph (1) or (2), as the case may be, shall not apply if the person deriving the dividends, being a resident of a Contracting State, carries on business in the other Contracting State

through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base. In such a case the provisions of Articles 7 (Business Profits), 14 (Independent Personal Services), or 17 (Artistes and Athletes), as the case may be, shall apply.

(5) Where a corporation which is a resident of a Contracting State (and not a resident of the other Contracting State) derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the corporation, except insofar as such dividends are paid to a resident of that other State (and where that other State is the United States, to a national of the United States) or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or fixed base situated in that other State, even if the dividends paid consist wholly or partly of profits or income arising in that other State.

(6) A corporation which is a resident of the United Kingdom shall be exempt from United States tax on its accumulated or undistributed earnings, profits, income or surplus, if individuals (other than nationals of the United States) who are residents of the United Kingdom control, directly or indirectly, throughout the last half of the taxable year, more than 50 per cent of the entire voting power in such corporation.

(7)

(a) If the beneficial owner of a dividend being a resident of a Contracting State owns 10 per cent or more of the class of shares of a corporation in respect of which the dividend is paid, then paragraph (1), or as the case may be paragraph (2), of this Article shall not apply to the dividend to the extent that it can have been paid only out of profits which the corporation paying the dividend earned or other income which it received in a period ending 12 months or more before the relevant date. For the purposes of this paragraph the term "relevant date" means the date on which the beneficial owner of the dividend

became the owner of 10 per cent or more of the class of shares in question.

(b) Paragraphs (1) and (2) of this Article shall not apply if:

(i) the recipient of the dividend is exempt from tax thereon in the United States; and

(ii) the dividend is paid in such circumstances that, if the recipient were a resident of the United Kingdom exempt from United Kingdom tax, the exemption would be limited or removed.

Provided that this paragraph shall not apply if the beneficial owner of the dividend shows that the shares were acquired for bona fide commercial reasons and not primarily for the purposes of securing the benefit of this Article.

Article 11 — Interest

(1) Interest derived and beneficially owned by a resident of the United Kingdom shall be exempt from tax by the United States.

(2) Interest derived and beneficially owned by a resident of the United States shall be exempt from tax by the United Kingdom.

(3) The term "interest" as used in this Article means income from Government securities, bonds or debentures, whether or not secured by mortgage and whether or not carrying a right to participate in profits, and other debt claims of every kind as well as all other income assimilated to income from money lent by the taxation law of the State in which the income arises but subject to the provisions of paragraph (7) of this Article shall not include any income which is treated as a distribution under the provisions of Article 10 (Dividends). Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.

(4) The provisions of paragraphs (1) and (2) shall not apply if the person deriving the interest, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the debt claim in respect of which the

interest is paid is effectively connected with such permanent establishment or fixed base. In such a case, the provisions of Article 7 (Business Profits), Article 14 (Independent Personal Services), or Article 17 (Artistes and Athletes), as the case may be, shall apply.

(5) Where, owing to a special relationship between the payer and the person deriving the interest or between both of them and some other person, the amount of the interest paid exceeds for whatever the reason the amount which would have been paid in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In that case, the excess part of the payments shall remain taxable according to the law of each Contracting State, due regard being had to the other provisions of this Convention.

(6) Whether or not a resident of a Contracting State derives profits or income from the other Contracting State, the other State may not impose any tax on the interest paid by that resident, except insofar as such interest is paid to a resident of that other State (and where that other State is the United States, to a national of the United States) or insofar as the debt claim in respect of which the interest is paid is effectively connected with a permanent establishment or a fixed base of the person deriving interest situated in that other State.

(7) Any provision in the law of either Contracting State relating only to interest paid to a non-resident corporation shall not operate so as to require such interest paid to a resident of the other Contracting State to be treated as a distribution by the corporation paying such interest. The preceding sentence shall not apply to interest paid to a corporation of one Contracting State in which more than 50 per cent of the voting power is controlled, directly or indirectly, by a person or persons who are residents of the other Contracting State.

(8) The provisions of paragraph (2) of this Article shall not apply if the recipient of the interest is exempt from tax on such income in the United States and such recipient sells or makes a contract to sell the holding from which such interest is derived

within three months of the date such recipient acquired such holding.

Article 12 — Royalties

(1) Royalties derived and beneficially owned by a resident of the United Kingdom shall be exempt from tax by the United States

(2) Royalties derived and beneficially owned by a resident of the United States shall be exempt from tax by the United Kingdom.

(3) The term "royalties" as used in this Article (a) means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work (but not including cinematographic films or films or tapes used for radio or television broadcasting); any patent, trade mark, design or model plan, secret formula or process, or other like right or property, or for information concerning industrial, commercial or scientific experience; and (b) shall include gains derived from the alienation of any such right or property which are contingent on the productivity, use, or disposition thereof; including the supply of assistance of an ancillary and subsidiary nature furnished as a means of enabling the application or enjoyment of any such right or property.

(4) The provisions of paragraphs (1) and (2) of this Article shall not apply if the person deriving the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment or fixed base. In such a case the provisions of Article 7 (Business Profits), Article 14 (Independent Personal Services), or Article 17 (Artistes and Athletes), as the case may be, shall apply.

(5) Where, owing to a special relationship between the payer and the person deriving the royalties or between both of them and some other person, the amount of the royalties paid exceeds for whatever reason the amount which would have been paid in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In that case, the excess part of the payments shall remain taxable according to the law of each Contracting State, due regard being had to the other provisions of this Convention.

Article 13 — Capital Gains

Except as provided in Article 8 (Shipping and Air Transport) of this Convention, each Contracting State may tax capital gains in accordance with the provisions of its domestic law.

Article 14 — Independent Personal Services

Income derived by an individual who is a resident of one of the Contracting States from the performance of personal services in an independent capacity may be taxed in that State. Such income may also be taxed in the other Contracting State if:

(a) the individual is present in that other State for a period or periods exceeding in the aggregate 183 days in the tax year concerned, but only so much thereof as is attributable to services performed in that State, or

(b) the individual has a fixed base regularly available to him in that other State for the purpose of performing his activities, but only so much thereof as is attributable to services performed in that State.

Article 15 — Dependent Personal Services

(1) Subject to the provisions of Articles 18 (Pensions) and 19 (Government Service), salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

(2) Notwithstanding the provisions of paragraph (1), remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:

(a) the recipient is present in that other State for a period not exceeding in the aggregate 183 days in the tax year concerned; and

(b) the remuneration is paid by, or on behalf of, an employer who is not a resident of that other State; and

(c) the remuneration is not borne as such by a permanent establishment or a fixed base which the employer has in that other State.

(3) Notwithstanding the preceding provisions of this Article, remuneration in respect of an employment as a member of the regular complement of a ship or aircraft in international traffic may be taxed by the Contracting State of which the employer operating the ship or aircraft is a resident.

Article 16 — Investment or Holding Companies

The provisions of Articles 10 (Dividends), 11 (Interest) or 12 (Royalties) of this Convention shall not apply to a corporation which is a resident of one of the Contracting States and which derives dividends, interest, or royalties arising within the other Contracting State if:

(a) (i) the tax imposed on the corporation by the first-mentioned Contracting State in respect of such dividends, interest or royalties is substantially less than the tax generally imposed by that State on corporate profits; or

(ii) the corporation is a resident of the United States and receives more than eighty per cent of its gross income from sources outside the United States as determined by and for the period prescribed in sections 861(a)(1)(B) and (a)(2)(A) of the internal Revenue Code of 1954, as they may be amended from time to time in minor respects so as not to affect their general principle; and

(b) 25 per cent or more of the capital of such corporation is owned directly or indirectly by one or more persons who are not individual residents of the first-mentioned Contracting State and are not nationals of the United States.

Article 17 — Artistes and Athletes

(1) Notwithstanding the provisions of Articles 14 (Independent Personal Services) and 15 (Dependent Personal Services), income derived by entertainers, such as theatre, motion picture, radio or television artistes, and musicians, and by athletes, from their personal activities as such may be taxed in the Contracting State in which these activities are exercised, except where the amount of the gross receipts derived by an entertainer or athlete, including expenses reimbursed to him or borne on his behalf, from such activities do not exceed 15,000 United States dollars or its equivalent in pounds sterling in the tax year concerned.

(2) Where income in respect of personal activities as such of an entertainer or athlete accrues not to that entertainer or athlete himself but to another person, that income may, not withstanding the provisions of Articles 7 (Business Profits), 14 Independent Personal Services), and 15 (Dependent Personal Services), be taxed in the Contracting State in which the activities of the entertainer or athlete are exercised. For the purposes of the preceding sentence, income of an entertainer or athlete shall be deemed not to accrue to another person if it is established that neither the entertainer or athlete, nor persons related thereto, participate directly or indirectly in the profits of such other person in any manner, including the receipt of deferred remuneration, bonuses, fees, dividends, partnership distributions or other distributions.

Article 18 — Pensions

(1) Subject to the provisions of paragraph (2) of Article 19 (Government Service), any pension in consideration of past employment and any annuity paid to an individual who is a resident of a Contracting State shall be taxed only in that State.

(2) Alimony paid to an individual who is a resident of one of the Contracting States by an individual who is a resident of the other Contracting State shall be exempt from tax in the other Contracting State.

(3) The term "annuity" means a stated sum payable periodically at stated times, during life or during a specified or ascertainable period of time, under an obligation to make the payments in return for adequate and full consideration in money or money's worth.

Article 19 — Government Service

(1)

(a) Remuneration, other than a pension, paid by a Contracting State to any individual in respect of services rendered to that State shall be taxable only in that State.

(b) However, such remuneration shall be taxable only in the other Contracting State if the services are rendered in that State and the recipient is a resident and a national of that State.

(2)

(a) Any pension paid by a Contracting State or a political subdivision or a local authority thereof to any individual in respect of services rendered to that State or subdivision or local authority thereof shall be taxable only in that State.

(b) However, such pension shall be taxable only in the other Contracting State if the recipient is a national of and a resident of that State.

(3) The provisions of Articles 14 (Independent Personal Services), 15 (Dependent Personal Services), 17 (Artists and Athletes), and 18 (Pensions), as the case may be, shall apply to remuneration and pensions in respect of services rendered in connection with any business carried on by or on behalf of one of the Contracting States or a political subdivision or a local authority thereof.

Article 20 — Teachers

(1) A professor or teacher who visits one of the Contracting States for a period not exceeding two years for the purpose of teaching or engaging in research at a university, college or other recognized educational institution in that Contracting State and who was immediately before that visit a resident of the other Contracting State, shall be exempted from tax by the first-mentioned Contracting State on any remuneration for such teaching or research for a period not exceeding two years from the date he first visits that State for such purpose.

(2) The exemption provided in this Article may be applied by the Contracting State in which the teaching or research is performed to current payments to such professor or teacher in anticipation of fulfilment of the requirements of paragraph (1) or by way of withholding and refund, but in either case exemption shall be conditioned upon fulfilment of the requirements of paragraph (1).

(3) This Article shall only apply to income from research if such research is undertaken by the professor or teacher in the public interest and not primarily for the benefit of some other private person or persons.

Article 21 — Students and Trainees

Payments which a student or business apprentice who was immediately before visiting a Contracting State a resident of the other Contracting State and who is present in the first-mentioned Contracting State for the purpose of his full-time education or training receives for the purpose of his maintenance, education or training shall not be taxed in that State, provided that such payments are made to him from sources outside that State.

Article 22 — Other Income

(1) Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State. The preceding sentence shall not apply to income paid out of trusts.

(2) The provisions of paragraph (1) shall not apply if the person deriving the income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the income is paid is effectively connected with such permanent establishment or fixed base. In such a case the provisions of Article 7 (Business Profits), Article 14 (Independent Personal Services), or Article 17 (Artists and Athletes), as the case may be, shall apply.

Article 23 — Elimination of Double Taxation

(1) In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), the United States shall allow to a resident or national of the United States as a credit against the United States tax the appropriate amount of tax paid to the United Kingdom; and, in the case of a United States corporation owning at least 10 per cent of the voting stock of a corporation which is a resident of the United Kingdom from which it receives dividends in any taxable year, the United States shall allow credit for the appropriate amount of tax paid to the United Kingdom by that corporation with respect to the profits out of which such dividends are paid. Such appropriate amount shall be based upon the amount of tax paid to the United Kingdom, but the credit shall not exceed the limitations (for the purpose of limiting the credit to the United States tax on income from sources outside of the United States) provided by United States law for the taxable year. For the purpose of applying the United States credit in relation to tax paid to the United Kingdom.

(a) the taxes referred to in paragraphs (2)(b) and (3) of Article 2 (Taxes Covered) shall be considered to be income taxes;

(b) the amount of 5 or 15 per cent, as the case may be, withheld under paragraph (2)(a)(i) or (ii) of Article 10

(Dividends) from the tax credit paid by the United Kingdom shall be treated as an income tax imposed on the recipient of the dividend; and

(c) that amount of tax credit referred to in paragraph (2)(a)(i) of Article 10 (Dividends) which is not paid to the United States corporation but to which an individual resident in the United Kingdom would have been entitled had he received the dividend shall be treated as an income tax imposed on the corporation paying the dividend.

(2) Subject to the provisions of the law of the United Kingdom regarding the allowance as a credit against United Kingdom tax of tax payable in a territory outside the United Kingdom (as it may be amended from time to time without changing the general principle hereof):

(a) United States tax payable under the laws of the United States and in accordance with the present Convention, whether directly or by deductions, on profits or income from sources within the United States (excluding in the case of a dividend, tax payable in respect of the profits out of which the dividend is paid) shall be allowed as a credit against any United Kingdom tax computed by reference to the same profits or income by reference to which the United States tax is computed;

(b) in the case of a dividend paid by a United States corporation to a corporation which is resident in the United Kingdom and which controls directly or indirectly at least 10 per cent of the voting power in the United States corporation, the credit shall take into account (in addition to any United States tax creditable under (a)) the United States tax payable by the corporation in respect of the profits out of which such dividend is paid.

(3) For the purposes of the preceding paragraphs of this Article, income or profits derived by a resident of a Contracting State which may be taxed in the other Contracting State in accordance with this Convention shall be deemed to arise from sources within the other Contracting State, except that where the United States taxes on the basis of citizenship, the United Kingdom shall not be bound to give credit to a United States

national who is resident in the United Kingdom on income from sources outside the United States as determined under the laws of the United Kingdom and the United States shall not be bound to give credit for United Kingdom tax on income received by such national from sources outside the United Kingdom, as determined under the laws of the United States.

(4) Notwithstanding sub-paragraph (a) of paragraph (1) of this Article, the amount of United Kingdom petroleum revenue tax allowable as a credit against United States tax shall be limited to the amount attributable to United Kingdom source taxable income in the following way, namely:

(a) The amount of United Kingdom petroleum revenue tax on income from the extraction of minerals from oil or gas wells in the United Kingdom to be allowed as a credit for a taxable year shall not exceed the amount, if any, by which the product of the maximum statutory United States tax rate applicable to a corporation for such taxable year and the amount of such income exceeds the amount of other United Kingdom tax on such income.

(b) The lesser of (i) the amount of United Kingdom petroleum revenue tax on income from the extraction of minerals from oil or gas wells in the United Kingdom that is not allowable as a credit under the preceding sub-paragraph, or (ii) 2 per cent of such income for the taxable year shall be deemed to be income taxes paid or accrued in the two preceding or five succeeding taxable years, to the extent not deemed paid or accrued in a prior taxable year, and shall be allowable as a credit in the year in which it is deemed paid or accrued subject to the limitation in sub-paragraph (a) above.

(c) The provisions of sub-paragraphs (a) and (b) shall apply, separately, *mutatis mutandis* (but with the deletion, in the case of (b), of the words "the lesser of (i)" and "or (ii) 2 per cent of such income for the taxable year"), to the amount of United Kingdom petroleum revenue tax on income from initial transportation, initial treatment and initial storage of minerals from oil or gas wells in the United Kingdom.

Article 24 — Nondiscrimination

(1) Individuals who are nationals of a Contracting State and who are residents of the other Contracting State shall not be subjected in that other State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected.

(2) The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities.

(3) Subject to the provisions of paragraph (4) of this Article, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, if reasonable in amount, be deductible for the purpose of determining the taxable profits of such enterprise under the same conditions as if they had been paid to a resident of the first-mentioned State. For the purposes of this paragraph, the term "other disbursements" shall include charges for amounts expended by such residents for the purposes of such enterprise, including a reasonable allocation of executive and general administrative expenses (except to the extent representing the expenses of a type of activity which is not for the benefit of such enterprise, but constitutes "stewardship" or "over-seeing" functions undertaken for such resident's own benefit as an investor in the enterprise), research and development in respect of which such enterprise has the benefits under a cost and risk sharing agreement and other expenses incurred by such resident for the benefit of a group of related enterprises including such enterprise.

(4) Paragraph (3) shall not apply to any interest, royalties, or other disbursements to which the provisions of Article 9 (Associated Enterprises), paragraphs (5) and (7) of Article 11 (Interest) or paragraph (5) of Article 12 (Royalties) apply.

(5) Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State shall not be

subjected in the first-mentioned contracting state to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

(6) Nothing contained in this Article shall be construed as obliging either Contracting State to grant to individuals not resident in that State any of the personal allowances and reliefs which are granted to individuals so resident.

Article 25 — Mutual Agreement Procedure

(1) Where a resident or national of a Contracting State considers that the actions of one or both of the Contracting States result or will result in taxation not in accordance with this Convention, he may, notwithstanding the remedies provided by the national laws of those States, present his case to the competent authority of the Contracting State of which he is a resident or national.

(2) The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at an appropriate solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation not in accordance with the Convention. Where an agreement has been reached, a refund as appropriate shall be made to give effect to the agreement.

(3) The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. In particular the competent authorities of the Contracting States may reach agreement on:

(a) the attribution of income, deductions, credits, or allowances of an enterprise of a Contracting State to its permanent establishment situated in the other Contracting State;

(b) the allocation of income, deductions, credits, or allowances between persons;

(c) the nature of particular items of income;

(d) the meaning of terms not otherwise defined in this Convention;

(e) the place where a particular item of income has its source;

(f) the elimination of double taxation in respect of income paid out of trusts.

(4) The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching agreement as contemplated by this Convention.

Article 26 — Exchange of Information and Administrative Assistance

(1) The competent authorities of the Contracting States shall exchange such information (being information available under the respective taxation laws of the Contracting States) as is necessary for carrying out the provisions of this Convention or for the prevention of fraud or the administration of statutory provisions against legal avoidance in relation to the taxes which are the subject of this Convention. Any information so exchanged shall be treated as secret but may be disclosed to persons (including a court or administrative body) concerned with the assessment, collection, enforcement or prosecution in respect of taxes which are the subject of this Convention. No information shall be exchanged which would disclose any trade, business, industrial or professional secret or any trade process.

(2) Each of the Contracting States will endeavour to collect on behalf of the other Contracting State such amounts as may be necessary to ensure that relief granted by this Convention from taxation imposed by such other Contracting State does not enure to the benefit of persons not entitled thereto. The United Kingdom will be regarded as fulfilling this obligation by the continuation of its existing arrangements for ensuring that relief from taxation imposed by the laws of the United States does not enure to the benefits of persons not entitled thereto.

(3) Paragraph (2) of this Article shall not impose upon either of the Contracting States the obligation to carry out administrative measures which are of a different nature from those used in the collection of its own tax, or which would be contrary to its sovereignty, security or public policy. In determining the administrative measures to be carried out, each Contracting State may take into account the administrative measures and practices of the other Contracting State in recovering taxes on behalf of the first-mentioned Contracting State.

(4) The competent authorities of the Contracting States shall consult with each other for the purpose of co-operating and advising in respect of any action to be taken in implementing this Article.

Article 27 — Effect on Diplomatic and Consular Officials and Domestic Laws

(1) Nothing in this Convention shall affect the fiscal privileges of diplomatic or consular officials under the general rules of international law or under the provisions of special agreements.

(2) This Convention shall not restrict in any manner any exclusion, exemption, deduction, credit, or other allowances now or hereafter accorded by the laws of either Contracting State.

Article 27A — Offshore Activities

(1) Notwithstanding the provisions of Article 5 (Permanent establishment) and Article 14 (Independent personal services), a person who is a resident of a Contracting State and carries on activities in the other Contracting State in connection with the exploration or exploitation of the seabed and sub-soil and their natural resources situated in that other Contracting State shall be deemed to be carrying on in respect of those activities a business in that other Contracting State through a permanent establishment or fixed base situated therein.

(2) The provisions of paragraph (1) shall not apply where the activities are carried on for a period not exceeding 30 days in aggregate in any 12 month period. However, for the purpose of this paragraph, activities carried on by any enterprise related to another enterprise shall be regarded as carried on by the enterprise to which it is related if the activities in question are substantially the same as those carried on by the last-mentioned enterprise.

(3) The provisions of Article 8 (Shipping and air transport) shall not apply to a drilling rig or any vessel the principal function of which is the performance of activities other than the transportation of goods or passengers.

Article 28 — Entry Into Force

(1) This Convention shall be ratified and the instruments of ratification shall be exchanged at Washington as soon as possible.

(2) This Convention shall enter into force immediately after the expiration of thirty days following the date on which the instruments of ratification are ~~exchanged and~~ shall thereupon have effect:

~~(a)~~ in the Untied Kingdom:

(i) in relation to any dividend to which subparagraph (2)(a)(ii) of Article 10 (Dividends) applies, in respect of income tax and payment of tax credit, for any year of assessment beginning on or after 6 April 1973. A dividend paid on or after 1 April 1973 and before 6 April 1973 shall be treated for tax credit purposes as paid on 6 April 1973;

(ii) in relation to paragraph (4) of Article 4 (Fiscal Residence), for any year of assessment beginning on or after 6 April 1976;

(iii) in relation to sub-paragraph (2)(a)(i) of Article 10 (Dividends) and any other provision (sic) of this Convention, in respect of income tax and payment of tax credit and in respect of capital gains tax, for any year of assessment beginning on or after 6 April 1975;

(iv) in respect of corporation tax, for any financial year beginning on or after 1 April 1975; and

(v) in respect of petroleum revenue tax, for any chargeable period beginning on or after 1 January 1975;

(b) in the United States:

(i) in respect of credits against United States tax allowed under paragraph (1) of Article 23 (Elimination of Double Taxation), for taxes paid to the United Kingdom on or after 1 April 1973;

(ii) in respect of tax withheld at the source, for amounts paid or credited on or after 1 January 1975; and

(iii) in respect of other taxes, for taxable years beginning on or after 1 January 1975.

(3) Subject to the provisions of paragraph (4) of this Article the Convention between the United Kingdom of Great Britain and Northern Ireland and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income signed at Washington on 16 April 1945, as amended by the Supplementary Protocol signed at Washington on 6 June 1946, by the Supplementary Protocol signed at Washington on 25 May 1954, by the Supplementary Protocol signed at Washington on 19 August 1957 and by the Supplementary Protocol signed at London on 17 March 1966 (hereinafter referred to as "the 1945 Convention"), shall cease to have effect in respect of taxes to which this Convention in accordance with the provisions of paragraph (2) of this Article applies.

(4) Where any provision of the 1945 Convention would have afforded any greater relief from tax any such provision as aforesaid shall continue to have effect:

(a) in the United Kingdom, for any year of assessment or financial year and

(b) in the United States, for any taxable year beginning in either case, before 1 January 1976.

(5) The 1945 Convention shall terminate on the last date on which it has effect in accordance with the foregoing provisions of this Article.

(6) This Convention shall not affect any Agreement in force extending the 1945 Convention in accordance with Article XXII thereof.

(7) Notwithstanding any provisions of the respective domestic laws of the Contracting States imposing time limits for applications for relief from tax, an application for relief under the provisions of this Convention shall have effect, and any consequential refunds of tax made, if the application is made to the competent authority concerned within three years of the end of the calendar year in which this Convention enters into force.

Article 29 — Termination

(1) This Convention shall remain in force indefinitely but either of the Contracting States may, on or before 30 June in any year after the year 1980, give to the other Contracting State, through diplomatic channels notice of termination and, in such event, the present Convention shall cease to be effective:

(a) in respect of United States tax, for the taxable years beginning on or after 1 January in the year next following that in which such notice is given;

(b)

(i) in respect of United Kingdom income tax and capital gains tax, for any year of assessment beginning on or after 6 April in the year next following that in which such notice is given;

(ii) in respect of United Kingdom corporation tax, for any financial year beginning on or after April 1 in the year next following that in which such notice is given;

(iii) in respect of United Kingdom petroleum revenue tax, for any chargeable period beginning on or after 1 January in the year next following that in which such notice is given.

(2) The termination of the present Convention shall not have the effect of reviving any treaty or arrangement abrogated by the present Convention or by treaties previously concluded between the Contracting States.

EXHIBIT 42

[Exchange of Notes between Honorable Allen J. MacEachen, Deputy Prime Minister and Minister of Finance of Canada and G. William Miller, Secretary of the United States Treasury, dated September 26, 1980.]

September 26, 1980

The Honorable
Allan J. MacEachen,
Deputy Prime Minister and
Minister of Finance of Canada

Sir:

I have the honor to acknowledge receipt of your note of September 26, 1980, which reads as follows:

"I have the honour to refer to the Convention between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed today, and to confirm certain understandings reached between the two Governments with respect to the Convention.

1. In French, the term "societe" also means a "corporation" within the meaning of Canadian law.

2. The competent authorities of each of the Contracting States shall review the procedures and requirements for an organization of the other Contracting State to establish its status as a religious, scientfic, literary, educational or charitable organization entitled to exemption under paragraph I of Article XXI (Exempt Organizations), or as an eligible recipient of the charitable contributions or gifts referred to in paragraphs 5 and 6 of Article XXI, with a view to avoiding duplicate application by such organizations to the administering agencies of both Contracting States.

If a Contracting State determines that the other Contracting State maintains procedures to determine such status and rules for qualification that are compatible with such procedures and rules of the first-mentioned Contracting State, it is contemplated that such first-mentioned Contracting State shall accept the certification of the administering agency of the other Contracting State as to such status for the purpose of making the necessary determinations under paragraphs 1, 5 and 6 of Article XXI.

It is further agreed that the term "family," as used in paragraphs 5 and 6 of Article XXI, means an individual's brothers and sisters (whether by whole or half-blood, or by adoption), spouse, ancestors, lineal descendants and adopted descendants.

3. It is the position of Canada that the so-called "unitary apportionment" method used by certain states of the United States to allocate income to United States offices or subsidiaries of Canadian companies results in inequitable taxation and imposes excessive administrative burdens on Canadian companies doing business in those states. Under that method the profit of a Canadian company on its United States business is not determined on the basis of arm's-length relations but is derived from a formula taking account of the income of the Canadian company and its world-wide subsidiaries as well as the assets, payroll and sales of all such companies. For a Canadian multinational company with many subsidiaries in different countries to have to submit its books and records for all of these companies to a state of the United States imposes a costly burden. It is understood that the Senate of the United States has not consented to any limitation on the taxing jurisdiction of the states by a treaty and that a provision which would have restricted the use of unitary apportionment in the case of United Kingdom corporations was recently rejected by the Senate. Canada continues to be concerned about this issue as it affects Canadian multinationals. If an acceptable provision on this subject can be devised, the United States agrees to reopen discussions with Canada on this subject.

4. I have the honour to propose to you that the present Note and your reply thereto shall constitute an agreement between our two Governments on these matters."

I confirm these understandings on behalf of the Government of the United States of America. These understandings constitute an agreement between our two Governments on this matter, which will enter into force on the date of entry into force of the Convention between the Government of the United States of

American and the Government of Canada with Respect to Taxes on Income and on Capital which was signed today.

Accept, Sir, the renewed assurances of my highest consideration.

(Signed by: G. William Miller
Secretary of the Treasury)

EXHIBIT 43

Income Tax Treaty-France

IN WITNESS WHEREOF, the respective plenipotentiaries have signed the present Protocol and affixed thereto their seals.

DONE at Washington in duplicate, in the English and French languages, both texts being equally authoritative, this 24th day of November, 1978.

For the President of the United States of America:

George S. Vest
Assistant Secretary of State
for European Affairs

For the President of the French Republic:

Francois de Laboulaye
Ambassador of France

Excellency:

In connection with the Protocol signed today, I should like to state our understanding with respect to two important unresolved issues and certain other matters concerning the application of the Protocol.

1. The United States takes the position that the tax credit (*avoir fiscal*) available to French investors in French corporations should extend on a nondiscriminatory basis to United States investors in French corporations. Under the terms of the Protocol signed in 1970 to the income tax convention between our two countries, the *avoir fiscal* is extended to United States portfolio investors. But in the absence of a similar extension to United States direct investors, the United States Government considers that the French tax credit system discriminates against investments made in France through the intermediary of a United States parent corporation, as compared to investments made by a French parent corporation.

We recognize the revenue concerns of France with respect to this issue and are prepared to accept, in the case of dividends from French subsidiaries to United States parent corporations, one half of the credit available to French shareholders less the 5 percent withholding tax at source allowed by the treaty (Article 9).

We are very concerned that the Government of France is not able to agree at this time to extend one half of the *avoir fiscal* to United States direct investors. We have agreed to conclude the Protocol without such a provision only because the change in French tax law which takes effect January 1, 1979 would otherwise subject United States citizens residing in France to double taxation, and we do not want them to be so penalized. We appreciate, however, that the Government of France will continue considering this issue and agrees to reopen discussions on the subject of the *avoir fiscal* as soon as feasible, and in any event if the credit is extended in full or in part to direct investors of other countries.

His Excellency
Francois de Laboulaye
Ambassador of France

2. It is the position of the Government of France that the so-called "unitary apportionment" method used by certain states of the United States to allocate income to the United States offices or subsidiaries of French corporations, results in inequitable taxation and imposes excessive administrative burdens on French corporations doing business in those states. Under that method the profit of a French company on its United States business is not determined on the basis of arm's length relations but is derived from a formula taking account of the income of the French company and its worldwide subsidiaries as well as the assets, payroll, and sales of all such companies.

For a French multinational corporation with many subsidiaries in different countries to have to submit its books and records for all of these corporations to a United States state, in English, imposes a costly burden.

It is understood that the Senate of the United States has not consented to any limitation on the taxing jurisdiction of the states by treaty and that a provision which would have restricted the use of unitary apportionment in the case of United Kingdom corporations was recently rejected by the Senate. The Government of France continues to be concerned about this issue as it affects French multinationals. If an acceptable provision on this subject

can be devised, the United States agrees to reopen discussions with France on this subject.

3. The Explanatory Note issued by the French and American Governments will cease to have effect for periods to which this Protocol applies. With respect to the taxation of American residents in France under this Convention, the two governments have agreed that:

a. Contributions to pension, profit-sharing, and other retirement plans which qualify under the United States Internal Revenue Code will not be considered income to an employee and will be deductible from the income of a self-employed individual, to the extent that such contributions are required by the terms of the plan and are comparable to similar French arrangements;

b. Payments received by the beneficiary in respect of the plans referred to in (a) will be included in income for French tax purposes, to the extent not exempt under subparagraph (2)(a)(ii)(c) of Article 23 of the Convention, at the time when, and to the extent that, such payments are considered gross income under the Internal Revenue Code;

c. Benefits received by reason of exercise of stock options will be considered compensation for French tax purposes at the time and to the extent the exercise of the option or disposition of stock gives rise to ordinary income for United States tax purposes;

d. United States state and local income taxes imposed in respect of income from personal services and any other business income (except income which is exempt from French tax under the Convention) shall be allowed as business expenses;

e. The French Government will attempt to reach a reasonable solution with American residents of France regarding the taxation of employer-provided benefits which are not considered income by the United States;

f. In applying the provisions of French law referred to by paragraph 2(c) of Article 23, the French Government clarified how the exemption with progression provision applies. The tax due is that proportion of the tax on total income which taxable (non-exempt) income bears to total (exempt plus taxable) in-

come. For example, if a taxpayer has a total income of $20,000 of which by reason of this Convention only $12,000 is taxable by France, the French tax will be 60 percent (12,000/20,000) of the tax computed on a total income of $20,000.

If this is in accord with your understanding, I would appreciate a confirmation from you to this effect.

Accept, Excellency, the renewed assurances of my highest consideration.

George S. Vest
Assistant Secretary
for European Affairs

* * *

EXHIBIT 44

MODEL DOUBLE TAXATION CONVENTION ON INCOME AND ON CAPITAL

Report
of the OECD Committee
on Fiscal Affairs

1977

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT
PARIS

The Organisation for Economic Co-operation and Development (OECD) was set up under a Convention signed in Paris on 14th December, 1960, which provides that the OECD shall promote policies designed:

— to achieve the highest sustainable economic growth and employment and a rising standard of living in Member countries, while maintaining financial stability, and thus to contribute to the development of the world economy;

— to conribute to sound economic expansion in Member as well as non-member countries in the process of economic development;

— to contribute to the expansion of world trade on a multilateral, on-discriminatory basis in accordance with international obligations.

The Members of OECD are Australia, Belgium, Canada, Denmark, Finland, France, the Federal Republic of Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.

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ANNEX I

MODEL CONVENTION FOR THE AVOIDANCE OF DOUBLE TAXATION WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL

[p. 21] SUMMARY OF THE CONVENTION

TITLE AND PREAMBLE

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Art. 24 Non-discrimination
Art. 25 Mutual agreement procedure
Art. 26 Exchange of information
Art. 27 Diplomatic agents and consular officers
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Final provisions

Art. 29 Entry into force
Art. 30 Termination

NOTE: In order to make it possible to compare the 1977 Model Convention with the 1963 Draft Convention, the text of the latter is reproduced at the end of this volume (Appendix III).

[p. 23] TITLE OF THE CONVENTION

Convention between (State A) and (State B) for the avoidance of double taxation with respect to taxes on income and on capital

PREAMBLE OF THE CONVENTION

NOTE: The Preamble of the Convention shall be drafted in accordance with the constitutional procedure of both Contracting States.

[p. 24] CHAPTER I

SCOPE OF THE CONVENTION

* * *

Article 2

TAXES COVERED

1. This Convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.

2. There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.

3. The existing taxes to which the Convention shall apply are in particular:

a) (in State A): ....

b) (in State B): ....

4. The Convention shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. At the end of each year, the competent authorities of the Contracting States shall notify each other of changes which have been made in their respective taxation laws.

[p. 25] CHAPTER II

DEFINITIONS

* * *

[p. 26] *Article 5*

PERMANENT ESTABLISHMENT

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" includes especially:

a) a place of management;

b) a branch;

c) an office;

d) a factory;

e) a workshop, and

f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

3. A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.

4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:

a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;

b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

[p. 27] *e*) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

f) the maintenance of a fixed place of business solely for any combination of activities mentioned in sub-paragraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person — other than an agent of an independent status to whom paragraph 6 applies — is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

[p. 28] CHAPTER III

TAXATION OF INCOME

* * *

Article 7

BUSINESS PROFITS

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

[p. 29] 3. In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.

4. Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.

5. No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

6. For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

7. Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

* * *

[p. 30] *Article 9*

ASSOCIATED ENTERPRISES

1. Where

a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State — and taxes accordingly — profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State, if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

* * *

[p. 41] CHAPTER VI

SPECIAL PROVISIONS

Article 24

NON-DISCRIMINATION

1. Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected. This provision shall, notwithstanding the provisions of Article 1, also apply to persons who are not residents of one or both of the Contracting States.

2. The term "nationals" means:

a) all individuals possessing the nationality of a Contracting State;

b) all legal persons, partnerships and associations deriving their status as such from the laws in force in a Contracting State.

3. Stateless persons who are residents of a Contracting State shall not be subjected in either Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of the State concerned in the same circumstances are or may be subjected.

4. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State

shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

5. Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, or paragraph 4 of Article 12, apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.

[p. 42] 6. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

7. The provisions of this Article shall, notwithstanding the provisions of Article 2, apply to taxes of every kind and description.

* * *

[p. 45] *ANNEX II*

COMMENTARIES ON THE ARTICLES OF THE MODEL CONVENTION

[p. 49] COMMENTARY ON ARTICLE 2 CONCERNING TAXES COVERED BY THE CONVENTION

This Article is intended to make the terminology and nomenclature relating to the taxes covered by the Convention more acceptable and precise, to ensure identification of the Contracting States' taxes covered by the Convention, to widen as much as possible the field of application of the Convention by including, as far as possible, and in harmony with the domestic laws of the Contracting States, the taxes imposed by their political subdivisions or local authorities, and to avoid the necessity of concluding a new convention whenever the Contracting States' domestic laws are modified by means of the periodical exchange of lists and through a procedure for mutual consultation.

Paragraph 1

2. This paragraph defines the scope of application of the Convention: taxes on income and on capital; the term "direct taxes" which is far too imprecise has therefore been avoided. It is immaterial on behalf of which authorities such taxes are imposed; it may be the State itself or its political subdivisions or local authorities (constituent States, regions, provinces, "départements", cantons, districts, "arrondissements", "Kreise", municipalities or groups of municipalities, etc.). The method of levying the taxes is equally immaterial: by direct assessment or by deduction at the source, in the form of surtaxes or surcharges, or as additional taxes ("centimes additionnels"), etc.

Paragraph 2

3. This paragraph gives a definition of taxes on income and on capital. Such taxes comprise taxes on total income and on elements of income, on total capital and on elements of capital. They also include taxes on profits and gains derived from the alienation of movable or immovable property, as well as taxes on capital appreciation. Finally, the definition extends to taxes on the total amounts of wages or salaries paid by undertakings ("payroll taxes"; in Germany "Lohnsummensteuer"; in France, "taxe sur les salaires"). Social security charges, or any other charges paid

where there is a direct connection between the levy and the individual benefits to be received, shall not be regarded as "taxes on the total amount of wages".

4. Clearly a State possessing taxing powers — and it alone — may levy the taxes imposed by its legislation together with any duties or charges accessory to them: increases, costs, interest, etc. It has not been considered necessary to specify this in the Article, as it is obvious that in the levying of the tax the accessory duties or charges depend on the same rule as the principal duty.

[p. 50] 5. The Article does not mention "ordinary taxes" or "extraordinary taxes". Normally, it might be considered justifiable to include extraordinary taxes in a Model Convention, but experience has shown that such taxes are generally imposed in very special circumstances. In addition, it would be difficult to define them. They may be extraordinary for various reasons; their imposition, the manner in which they are levied, their rates, their objects, etc. This being so, it seems preferable not to include extraordinary taxes in the Article. But, as it is not intended to exclude extraordinary taxes from all conventions, ordinary taxes have not been mentioned either. The Contracting States are thus free to restrict the convention's field of application to ordinary taxes, to extend it to extraordinary taxes, or even to establish special provisions.

Paragraph 3

6. This paragraph lists the taxes in force at the time of signature of the convention. The list is not exhaustive. It serves to illustrate the preceding paragraphs of the Article. In principle, however, it will be a complete list of taxes imposed in each State at the time of signature and covered by the convention.

Paragraph 4

7. This paragraph provides, since the list of taxes in paragraph 3 is purely declaratory, that the Convention is also to apply to all identifical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. This provision is necessary to prevent the

Convention from becoming inoperative in the event of one of the States modifying its taxation laws.

8. Each State undertakes to notify the other of any amendments made to its taxation laws by communicating to it at the end of each year, when necessary, a list of new or substituted taxes, imposed during that year.

OBSERVATION ON THE COMMENTARY

9. In contexts such as limitations on the rate of tax or the granting of credits for foreign tax, *New Zealand* would wish to make it clear that the term "tax" does not include penalties.

RESERVATIONS ON THE ARTICLE

10. *Australia, Canada* and the *United States* reserve their positions on that part of paragraph 1 which states that the Convention should apply to taxes of political subdivisions or local authorities.

11. *Japan* reserves its position on that part of paragraph 1 which states that the Convention shall apply to taxes on capital.

* * *

[p. 59] COMMENTARY ON ARTICLE 5 CONCERNING THE DEFINITION OF PERMANENT ESTABLISHMENT

1. The main use of the concept of a permanent establishment is to determine the right of a Contracting State to tax the profits of an enterprise of the other Contracting State. Under Article 7 a Contracting State cannot tax the profits of an enterprise of the other Contracting State unless it carries on its business through a permanent establishment situated therein.

Paragraph 1

2. Paragraph 1 gives a general definition of the term "permanent establishment" which brings out its essential characteristics of a permanent establishment in the sense of the Convention, i.e.,

a distinct "situs", a "fixed place of business". The paragraph defines the term "permanent establishment" as a fixed place of business, through which the business of an enterprise is wholly or partly carried on. This definition, therefore, contains the following conditions:

- — the existence of a "place of business", i.e. a facility such as premises or, in certain instances, machinery or equipment;
- — this place of business must be "fixed", i.e. it must be established at a distinct place with a certain degree of permanence;
- — the carrying on of the business of the enterprise through this fixed place of business. This means usually that persons who, in one way or another, are dependent on the enterprise (personnel) conduct the business of the enterprise in the State in which the fixed place is situated.

3. It could perhaps be argued that in the general definition some mention should also be made of the other characteristic of a permanent establishment to which some importance has sometimes been attached in the past, namely that the establishment must have a productive character — i.e. contribute to the profits of the enterprise. In the present definition this course has not been taken. Within the framework of a well-run business organisation it is surely axiomatic to assume that each part contributes to the productivity of the whole. It does not, of course, follow in every case that because in the wider context of the whole organisation a particular establishment has a "productive character" it is consequently a permanent establishment to which profits can properly be attributed for the purpose of tax in a particular territory (cf. Commentary on paragraph 4).

4. The term "place of business" covers any premises, facilities or installations used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose. A place of business may also exist where no premises are available or required for carrying on the business of the enterprise and it simply has a certain amount of space at its disposal. It is immaterial whether the premises, facilities or installations are

owned or rented by or are otherwise at the disposal of the enterprise. A place of business may thus be constituted [p. 60] by a pitch in a market place, or by a certain permanently used area in a Customs depot (e.g., for the storage of dutiable goods). Again the place of business may be situated in the business facilities of another enterprise. This may be the case, for instance where the foreign enterprise has at its constant disposal certain premises or a part thereof owned by the other enterprise.

5. According to the definition, the place of business has to be a "fixed" one. Thus in the normal way there has to be a link between the place of business and a specific geographical point. It is immaterial how long an enterprise of a Contracting State operates in the other Contracting State if it does not do so at a distinct place, but this does not mean that the equipment constituting the place of business has to be actually fixed to the soil on which it stands. It is enough that the equipment remains on a particular site (but cf. paragraph 19 below):

6. Since the place of business must be fixed, it also follows that a permanent establishment can be deemed to exist only if the place of business has a certain degree of permanency, i.e., if it is not a purely temporary nature. If the place of business was not set up merely for a temporary purpose, it can constitute a permanent establishment, even though it existed, in practice, only for a very short period of time because of the special nature of the activity of the enterprise or because, as a consequence of special circumstances (e.g. death of the taxpayear, investment failure), it was prematurely liquidated. Where a place of business which was, at the outset, designed for a short temporary purpose only, is maintained for such a period that it cannot be considered as a temporary one, it becomes a fixed place of business and thus — retrospectively — a permanent establishment.

7. For a place of business to constitute a permanent establishment the enterprise using it must carry on its business wholly or partly through it. As stated in paragraph 3 above, the activity need not be of a productive character. Furthermore, the activity need not be permanent in the sense that there is no interruption of operation, but operations must be carried out on a regular basis.

8. Where tangible property such as facilities, equipment, buildings, or intangible property such as patents, procedures and similar property, are let or leased to third parties through a fixed place of business maintained by an enterprise of a Contracting State in the other State, this activity will, in general, render the place of business a permanent establishment. The same applies if capital is made available through a fixed place of business. If an enterprise of a State lets or leases facilities, equipment, buildings or intangible property to an enterprise of the other State without maintaining for such letting or leasing activity a fixed place of business in the other State, the leased facility, equipment, building or intangible property, as such, will not constitute a permanent establishment of the lessor provided the contract is limited to the mere leasing of the equipment, etc. This remains the case even when, for example, the lessor supplies personnel after installation to operate the equipment provided that their responsibility is limited solely to the operation or maintenance of the equipment under the direction, responsibility and control of the lessee. If the personnel have wider responsibilities, for example, participation in the decisions regarding the work for which the equipment is used, the activity of the lessor may go beyond the mere leasing of equipment and may constitute an enterpreneurial activity. In such a case a permanent establishment could be deemed to exist if the criterion of permanency is met. When such activity is connected with, or is similar in character to, those mentioned in paragraph 3, the time limit of twelve months applies. Other cases have to be determined according to the circumstances.

[p. 61] 9. The business of an enterprise is carried on mainly by the entrepreneur or persons who are in a paid-employment relationship with the enterprise (personnel). This personnel includes employees and other persons receiving instructions from the enterprise (e.g. dependent agents). The powers of such personnel in its relationship with third parties are irrelevant. It makes no difference whether or not the dependent agent is authorised to conclude contracts if he works at the fixed place of business (cf. paragraph 34 below). But a permanent establishment may nevertheless exist if the business of the enterprise is carried on mainly through automatic equipment, the activities of the personnel being restricted to setting up, operating, controlling

and maintaining such equipment. Whether or not gaming and vending machines and the like set up by an enterprise of a State in the other State constitute a permanent establishment thus depends on whether or not the enterprise carries on a business activity besides the initial setting up of the machines. A permanent establishment does not exist if the enterprise merely sets up the machines and then leases the machines to other enterprises. A permanent establishment may exist, however, if the enterprise which sets up the machines also operates and maintains them for its own account. This also applies if the machines are operated and maintained by an agent dependent on the enterprise.

10. A permanent establishment begins to exist as soon as the enterprise commences to carry on its business through a fixed place of business. This is the case once the enterprise prepares, at the place of business, the activity for which the place of business is to serve permanently. The period of time during which the fixed place of business itself is being set up by the enterprise should not be counted, provided that this activity differs substantially from the activity for which the place of business is to serve permanently. The permanent establishment ceases to exist with the disposal of the fixed place of business or with the cessation of any activity through it, that is when all acts and measures connected with the former activities of the permanent establishment are terminated (winding up current business transactions, maintenance and repair of facilities). A temporary interruption of operations, however, cannot be regarded as a closure. If the fixed place of business is leased to another enterprise, it will normally only serve the activities of that enterprise instead of the lessor's; in general, the lessor's permanent establishment ceases to exist, except where he continues carrying on a business activity of his own through the fixed place of business.

Paragraph 2

11. This paragraph contains a list, by no means exhaustive, of examples, each of which can be regarded, prima facie, as constituting a permanent establishment. As these examples are to be seen against the background of the general definition given in paragraph 1, it is assumed that the Contracting States interpret

the terms listed, "a place of management", "a branch", "an office", etc. in such a way that such places of business constitute permanent establishments only if they meet the requirements of paragraph 1.

12. The term "place of management" has been mentioned separately because it is not necessarily an "office". However, where the laws of the two Contracting States do not contain the concept of a "place of management" as distinct from an "office", there will be no need to refer to the former term in their bilateral convention.

13. Sub-paragraph f) provides that mines, oil or gas wells, quarries or any other place of extraction of natural resources are permanent establishments. The [p. 62] term "any other place of extraction of natural resources" should be interpreted broadly. It includes, for example, all places of extraction of hydrocarbons whether on or off-shore.

14. Sub-paragraph f) refers to the extraction of natural resources, but does not mention the exploration of such resources, whether on or off-shore. Therefore, whenever income from such activities is considered to be business profits, the question whether these activities are carried on through a permanent establishment is governed by paragraph 1. Since, however, it has not been possible to arrive at a common view on the basic questions of the attribution of taxation rights and of the qualification of the income from exploration activities, the Contracting States may agree upon the insertion of specific provisions. They may agree, for instance, that an enterprise of a Contracting State, as regards its activities of exploration of natural resources in a place or area in the other Contracting State:

a) shall be deemed not to have a permanent establishment in that other State; or

b) shall be deemed to carry on such activities through a permanent establishment in that other State; or

c) shall be deemed to carry on such activities through a permanent establishment in that other State if such activities last longer than a specified period of time.

The Contracting States may moreover agree to submit the income from such activities to any other rule.

Paragraph 3

15. This paragraph provides expressly that a building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months. Any of those items which does not meet this condition does not of itself constitute a permanent establishment, even if there is within it an installation, for instance an office or a workshop within the meaning of paragraph 2, associated with the construction activity.

16. The term "building site or construction or installation project" includes not only the construction of buildings but also the construction of roads, bridges or canals, the laying of pipe-lines and excavating and dredging. Planning and supervision of the erection of a building are covered by this term, if carried out by the building contractor. However, planning and supervision is not included if carried out by another enterprise whose activities in connection with the construction concerned are restricted to planning and supervising the work. If that other enterprise has an office which it uses only for planning or supervision activities relating to a site or project which does not constitute a permanent establishment, such office does not constitute a fixed place of business within the meaning of paragraph 1, because its existence has not a certain degree of permanence.

17. The twelve month test applies to each individual site or project. In determining how long the site or project has existed, no account should be taken of the time previously spent by the contractor concerned on other sites or projects which are totally unconnected with it. A building site should be regarded as a single unit, even if it is based on several contracts, provided that it forms a coherent whole commercially and geographically. Subject to this proviso, a [p. 63] building site forms a single unit even if the orders have been placed by several persons (e.g. for a row of houses).

18. A site exists from the date on which the contractor begins his work, including any preparatory work, in the country where

the construction is to be established, e.g. if he installs a planning office for the construction. In general, it continues to exist until the work is completed or permanently abandoned. A site should not be regarded as ceasing to exist when work is temporarily discontinued. Seasonal or other temporary interruptions should be included in determining the life of a site. Seasonal interruptions include interruptions due to bad weather. Temporary interruption could be caused, for example, by shortage of material or labour difficulties. Thus, for example, if a contractor started work on a road on 1st May, stopped on 1st November because of bad weather conditions or a lack of materials but resumed work in 1st February the following year, completing the road on 1st June, his construction project should be regarded as a permanent establishment because thirteen months elapsed between the date he first commenced work (1st May) and the date he finally finished (1st June of the following year). If an enterprise (general contractor) which has undertaken the performance of a comprehensive project sub-contracts parts of such a project to other enterprises (sub-contractors), the period spent by a sub-contractor working on the building site must be considered as being time spent by the general contractor on the building project. The sub-contractor himself has a permanent establishment at the site if his activities there last more than twelve months.

19. The very nature of a construction or installation project may be such that the contractor's activity has to be relocated continuously or at least from time to time, as the project progresses. This would be the case for instance where roads or canals were being constructed, waterways dredged, or pipe-lines laid. In such a case, the fact that the work force is not present for twelve months in one particular place is immaterial. The activities performed at each particular spot are part of a single project, and that project must be regarded as a permanent establishment if, as a whole, it lasts more than twelve months.

Paragraph 4

20. This paragraph lists a number of business activities which are treated as exceptions to the general definition laid down in paragraph 1 and which are not permanent establishments, even if

the activity is carried on through a fixed place of business. The common feature of these activities is that they are, in general, preparatory or auxiliary activities. This is laid down explicitly in the case of the exception mentioned in sub-paragraph *e*), which actually amounts to a general restriction of the scope of the definition contained in paragraph 1. Moreover sub-paragraph *f*) provides that combinations of activities mentioned in sub-paragraphs *a*) to *e*) in the same fixed place of business shall be deemed not to be a permanent establishment, provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character. Thus the provisions of paragraph 4 are designed to prevent an enterprise of one State from being taxed in the other State, if it carries on in that other State, activities of a purely preparatory or auxiliary character.

21. Sub-paragraph *a*) relates only to the case in which an enterprise acquires the use of facilities for storing, displaying or delivering its own goods or merchandise. Sub-paragraph *b*) relates to the stock of merchandise itself and provides that the stock, as such, shall not be treated as a permanent establishment if it is [p. 64] maintained for the purpose of storage, display or delivery. Sub-paragraph *c*) covers the case in which a stock of goods or merchandise belonging to one enterprise is processed by a second enterprise, on behalf of, or for the account of, the first-mentioned enterprise. The reference to the collection of information in sub-paragraph *d*) is intended to include the case of the newspaper bureau which has no purpose oher than to act as one of many "tentacles" of the parent body; to exempt such a bureau is to do no more than to extend the concept of "mere purchase".

22. Sub-paragraph *e*) provides that a fixed place of business through which the enterprise exercises solely an activity which has for the enterprise a preparatory or auxiliary character, is deemed not to be a permanent establishment. The wording of this sub-paragraph makes it unnecessary to produce an exhaustive list of exceptions. Furthermore, this sub-paragraph provides a generalised exception to the general definition in paragraph 1 and, when read with that paragraph, provides a more selective test, by which to determine what constitutes a permanent establishment.

To a considerable degree it limits that definition and excludes from its rather wide scope a number of forms of business organisations which, although they are carried on through a fixed place of business, should not be treated as permanent establishments. It is recognised that such a place of business may well contribute to the productivity of the enterprise, but the services it performs are so remote from the actual realisation of profits that it is difficult to allocate any profit to the fixed place of business in question. Examples are fixed places of business solely for the purpose of advertising or for the supply of information or for scientific research or for the servicing of a patent or a know-how contract, if such activities have a preparatory or auxiliary character.

23. It is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not. The decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and signifciant part of the activity of the enterprise as a whole. Each individual case will have to be examined on its own merits. In any case, a fixed place of business whose general purpose is one which is identical to the general purpose of the whole enterprise, does not exercise a preparatory or auxiliary activity. Where, for example, the servicing of patents and know-how is the purpose of an enterprise, a fixed place of business of such enterprise exercising such an activity cannot get the benefits of sub-paragraph *e*). A fixed place of business which has the function of managing an enterprise or even only a part of an enterprise or of a group of the concern cannot be regarded as doing a preparatory or auxiliary activity, for such a managerial activity exceeds this level. If enterprises with international ramifications establish a so-called "management office" in States in which they maintain subsidiaries, permanent establishments, agents or licensees, such office having supervisory and co-ordinating functions for all departments of the enterprise located within the region concerned, a permanent establishment will normally be deemed to exist, because the management office may be regarded as an office within the meaning of paragraph 2. Where a big international concern has delegated all management functions to its regional management offices so that the functions of the head office of the concern

are restricted to general supervision (so-called polycentric enterprises), the regional management offices even have to be regarded as a "place of management" within the meaning of sub-paragraph *a*) of paragraph 2. The function of managing an enterprise, even if it only covers a certain area of the operations of the concern, constitutes an essential part of the business operations of the enterprise and therefore can [p. 65] in no way be regarded as an activity which has a preparatory or auxiliary character within the meaning of sub-paragraph *e*) of paragraph 4.

24. A permanent establishment could also be constituted if an enterprise maintains a fixed place of business in order to supply spare parts to customers for the machinery supplied to such customers, and to maintain and repair such machinery as this goes beyond the pure delivery mentioned in sub-paragraph *a*) of paragraph 4. Since these after-sale organisations perform an essential and significant part of the services of an enterprise vis-à-vis its customers, their activities are not merely auxiliary ones. Sub-paragraph *e*) applies only if the activity of the fixed place of business is limited to a preparatory or auxiliary one. This would not be the case where, for example, the fixed place of business does not only give information but also furnishes plans etc. specially developed for the purposes of the individual customer. Nor would it be the case if a research establishment were to concern itself with manufacture.

25. Moreover, sub-paragraph *e*) makes it clear that the activities of the fixed place of business must be carried on for the enterprise. A fixed place of business which renders services not only to its enterprise but also directly to other enterprises, for example to other companies of a group to which the company owning the fixed place belongs, would not fall within the scope of sub-paragraph *e*).

26. As already mentioned in paragraph 20 above, paragraph 4 is designed to provide for exceptions to the general definition of paragraph 1 in respect of fixed places of business which are engaged in activities having a preparatory or auxiliary character. Therefore, according to sub-paragraph *f*) of paragraph 4, the fact that one fixed place of business combines any of the activities mentioned in the sub-paragraphs *a*) to *e*) of paragraph 4 does not

mean of itself that a permanent establishment exists. As long as the combined activity of such a fixed place of business is merely preparatory or auxiliary a permanent establishment should be deemed not to exist. Such combinations should not be viewed on rigid lines, but should be considered in the light of the particular circumstances. The criterion "preparatory or auxiliary character" is to be interpreted in the same way as is set out for the same criterion of sub-paragraph *e*) (cf. paragraphs 23 and 24 above). Sub-paragraph *f*) is of no importance in a case where an enterprise maintains several fixed places of business within the meaning of the sub-paragraphs *a*) to *e*) provided that they are separated from each other locally and organisationally, as in such a case each place of business has to be viewed separately and in isolation for deciding the question whether or not a permanent establishment exists. States which want to allow any combination of the items mentioned in sub-paragraphs *a*) to *e*), disregarding whether or not the criterion of the preparatory or auxiliary charater of such a combination is met, are free to do so by deleting the words "provided" to "character" in sub-paragraph *f*).

27. The fixed places of business mentioned in paragraph 4 cannot be deemed to constitute permanent establishments so long as their activities are restricted to the functions which are the prerequisite for assuming that the fixed place of business is not a permanent establishment. This will be the case even if the contracts necessary for establishing and carrying on the business are concluded by those in charge of the places of business themselves. The employees of places of business within the meaning of paragraph 4 who are authorised to conclude such contracts should not be regarded as agents within the meaning of paragraph 5. A case in point would be a research institution the manager of which is authorised to conclude [p. 66] the contracts necessary for maintaining the institution and who exercises this authority within the framework of the functions of the institution. A permanent establishment, however, exists if the fixed place of business exercising any of the functions listed in paragraph 4 were to exercise them not only on behalf of the enterprise to which it belongs but also on behalf of other enterprises. If, for instance, an advertising agency maintained by an enterprise were also to engage in advertising for other enterprises, it would be regarded as

a permanent establishment of the enterprise by which it is maintained.

28. If a fixed place of business under paragraph 4 is deemed not to be a permanent establishment, this exception applies likewise to the disposal of movable property forming part of the business property of the place of business at the termination of the enterprise's activity in such installation (cf. paragraph 10 above and paragraph 2 of Article 13). Since, for example, the display of merchandise is excepted under sub-paragraphs *a*) and *b*), the sale of the merchandise at the termination of a trade fair or convention is covered by this exception. The exception does not, of course, apply to sales of merchandise not actually displayed at the trade fair or convention.

29. A fixed place of business used both for activities which rank as exceptions (paragraph 4) and for other activities would be regarded as a single permanent establishment and taxable as regards both types of activities. This would be the case, for instance, where a store maintained for the delivery of goods also engaged in sales.

Paragraph 5

30. It is a generally accepted principle that an enterprise should be treated as having a permanent establishment in a State if there is under certain conditions a person acting for it, even though the enterprise may not have a fixed place of business in that State within the meaning of paragraphs 1 and 2. This provision intends to give that State the right to tax in such cases. Thus paragraph 5 stipulates the conditions under which an enterprise is deemed to have a permanent establishment in respect of any activity of a person acting for it. The paragraph has been redrafted to clarify the intention of the corresponding provision of the 1963 Draft Convention without altering its substance apart from an extension of the excepted activities of the person.

31. Persons whose activities may create a permanent establishment for the enterprise are so-called dependent agents i.e. persons, whether employees or not, who are not independent

agents falling under paragraph 6. Such persons may be either individuals or companies. It would not have been in the interest of international economic relations to provide that the maintenance of any dependent person would lead to a permanent establishment for the enterprise. Such treatment is to be limited to persons who in view of the scope of their authority or the nature of their activity involve the enterprise to a particular extent in business activities in the State concerned. Therefore, paragraph 5 proceeds on the basis that only persons having the authority to conclude contracts can lead to a permanent establishment for the enterprise maintaining them. In such a case the person has sufficient authority to bind the enterprise's participation in the business activity in the State concerned. The use of the term "permanent establishment" in this context presupposes, of course, that that person makes use of this authority repeatedly and not merely in isolated cases.

[p. 67] 32. The authority to conclude contracts must cover contracts relating to operations which constitute the business proper of the enterprise. It would be irrelevant, for instance, if the person had authority to engage employees for the enterprise to assist that person's activity for the enterprise or if the person were authorised to conclude, in the name of the enterprise, similar contracts relating to internal operations only. Moreover the authority has to be habitually exercised in the other State; whether or not this is the case should be determined on the basis of the commercial realities of the situation. A person who is authorized to negotiate all elements and details of a contract in a way binding on the enterprise can be said to exercise this authority "in that State", even if the contract is signed by another person in the State in which the enterprise is situated. Since, by virtue of paragraph 4, the maintenance of a fixed place of business solely for purposes listed in that paragraph is deemed not to constitute a permanent establishment, a person whose activities are restricted to such purposes does not create a permanent establishment either.

33. Where the requirements set out in paragraph 5 are met, a permanent establishment of the enterprise exists to the extent that the person acts for the latter, i.e. not only to the extent that such a

person exercises the authority to conclude contracts in the name of the enterprise.

34. Under paragraph 5, only those persons who meet the specific conditions, may create a permanent establishment; all other persons are excluded. It should be borne in mind, however, that paragraph 5 simply provides an alternative test of whether an enterprise has a permanent establishment in a State. If it can be shown that the enterprise has a permanent establishment within the meaning of paragraphs 1 and 2 (subject to the provisions of paragraph 4), it is not necessary to show that the person in charge is one who would fall under paragraph 5.

Paragraph 6

35. Where an enterprise of a Contracting State carries on business dealings through a broker, general commission agent or any other agent of an independent status, it cannot be taxed in the other Contracting State in respect of those dealings if the agent is acting in the ordinary course of his business (cf. paragraph 31 above). Although it stands to reason that such an agent, representing a separate enterprise, cannot constitute a permanent establishment of the foreign enterprise, paragraph 6 has been inserted in the Article for the sake of clarity and emphasis.

36. A person will come within the scope of paragraph 6 — i.e. he will not constitute a permanent establishment of the enterprise on whose behalf he acts — only if

a) he is independent of the enterprise both legally and economically, and

b) he acts in the ordinary course of this business when acting on behalf of the enterprise.

37. Whether a person is independent of the enterprise represented depends on the extent of the obligations which this person has vis-à-vis the enterprise. Where the person's commercial activities for the enterprise are subject to detailed instructions or to comprehensive control by it, such person cannot be regarded as independent of the enterprise. Another important criterion will be whether the entrepreneurial risk has to be borne by the person or

by the enterprise the person represents. A subsidiary is not to be considered dependent on its parent company solely because of the parent's ownership of the share capital. Persons cannot be [p. 68] said to act in the ordinary course of their own business if, in place of the enterprise, such persons perform activities which, economically, belong to the sphere of the enterprise rather than to that of their own business operations. Where, for example, a commission agent not only sells the goods or merchandise of the enterprise in his own name but also habitually acts, in relation to that enterprise, as a permanent agent having an authority to conclude contracts, he would be deemed in respect of this particular activity to be a permanent establishment, since he is thus acting outside the ordinary course of his own trade or business (namely that of a commission agent), unless his activities are limited to those mentioned at the end of paragraph 5.

38. According to the definition of the term "permanent establishment" an insurance company of one State may be taxed in the other State on its insurance business, if it has a fixed place of business within the meaning of paragraph 1 or if it carries on business through a person within the meaning of paragraph 5. Since agencies of foreign insurance companies sometimes do not meet either of the above requirements, it is conceivable that these companies do large-scale business in a State without being taxed in that State on their profits arising from such business. In order to obviate this possibility, various conventions concluded by OECD Member countries include a provision which stipulates that insurance companies of a State are deemed to have a permanent establishment in the other State if they collect premiums in that other State through an agent established there — other than an agent who already constitutes a permanent establishment by virtue of paragraph 5 — or insure risks situated in that territory through such an agent. The decision as to whether or not a provision along these lines should be included in a convention will depend on the factual and legal situation prevailing in the Contracting States concerned. Frequently, therefore, such a provision will not be contemplated. In view of this fact, it did not seem advisable to insert a provision along these lines in the Model Convention.

Paragraph 7

39. It is generally accepted that the existence of a subsidiary company does not, of itself, constitute that subsidiary company a permanent establishment of its parent company. This follows from the principle that, for the purpose of taxation, such a subsidiary company constitutes an independent legal entity. Even the fact that the trade or business carried on by the subsidiary company is managed by the parent company does not constitute the subsidiary company a permanent establishment of the parent company.

40. However, a subsidiary company will constitute a permanent establishment for its parent company under the same conditions stipulated in paragraph 5 as are valid for any other unrelated company, i.e. if it cannot be regarded as an independent agent in the meaning of paragraph 6, and if it has and habitually exercises an authority to conclude contracts in the name of the parent company. And the effects would be the same as for any other unrelated company to which paragraph 5 applies.

41. The same rules should apply to activities which one subsidiary carries on for any other subsidiary of the same company.

Observations on the Commentary

42. Treatment in Irish tax law of non-resident operators in *Ireland* and in the Irish continental shelf area. Profits arising to a person not resident in Ireland [p. 69] from exploration or exploitation activities in Ireland or in the Irish continental shelf area as well as profits from exploration or exploitation rights are treated as the profits of a trade carried on in Ireland through a branch or agency and are, in consequence, taxable in Ireland. This includes non-resident contractors who supply well-drilling, pipe-laying and similar services in Ireland or in the Irish continental shelf area. In addition, capital gains accruing on the disposal of exploration or exploitation rights in Ireland or in the Irish continental shelf area are treated as gains accruing on the disposal of assets situated in Ireland. When negotiating conventions with other Member countries, Ireland would wish subparagraph *f)* of paragraph 2 to be so drafted and interpreted as to reflect the Irish position.

43. *Italy* does not adhere to the interpretation given in paragraph 11 above concerning the list of examples of paragraph 2. In its opinion, these examples can always be regarded as constituting "a priori" permanent establishments.

44. While, subject to its reservations in relation to this Article, *New Zealand,* for the purpose of negotiating conventions with other Member countries, accepts, in general, the principles of this Article, it would wish to be free to negotiate for the addition of specific provisions deeming an enterprise in some particular situations to have a permanent establishment in New Zealand.

Reservations on the Article

45. *Australia* reserves the right to treat an enterprise as having a permanent establishment in a State if the enterprise carries on designated supervisory activities in that state for more than twelve months, if substantial equipment is used in that State for more than twelve months by, for or under contract with the enterprise in the exploration of natural resources, or if a person acting in that State on behalf of the enterprise — manufactures or processes there goods or merchandise belonging to the enterprise.

46. *Greece, New Zealand, Portugal* and *Turkey* reserve their positions on paragraph 3, and consider that any building site or construction or installation project which lasts more than six months should be regarded as a permanent establishment.

47. *New Zealand* also reserves its position so as to be able to tax an enterprise which carries on supervisory activities for more than six months in connection with a building site or construction or installation project lasting more than six months, and also an enterprise where substantial equipment or machinery is for more than six months being used by, for or under contract with the enterprise.

48. *Spain* reserves its position on paragraph 3 so as to be able to tax an enterprise having a permanent establishment in Spain, even if the site of the construction or installation project does not last for more than twelve months, where the activity of this enterprise in Spain presents a certain degree of permanency within the meaning of paragraphs 1 and 2.

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[p. 72] COMMENTARY ON ARTICLE 7 CONCERNING THE TAXATION OF BUSINESS PROFITS

I. Preliminary remarks

1. This Article is in many respects a continuation of, and a corollary to, Article 5 on the definition of the concept of permanent establishment. The permanent establishment criterion is commonly used in international double taxation conventions to determine whether a particular kind of income shall or shall not be taxed in the country from which it originates but the criterion does not of itself provide a complete solution to the problem of the double taxation of business profits; in order to prevent such double taxation it is necessary to supplement the definition of permanent establishment by adding to it an agreed set of rules of reference to which the profits made by the permanent establishment, or by an enterprise trading with a foreign member of the same group of enterprises, are to be calculated. To put the matter in a slightly different way, when an enterprise of a Contracting State carries on business in the other Contracting State the authorities of that second State have to ask themselves two questions before they levy tax on the profits of the enterprise: the first question is whether the enterprise has a permanent establishment in their country; if the answer is in the affirmative the second question is what, if any, are the profits on which that permanent establishment should pay tax. It is with the rules to be used in determining the answer to this second question that Article 7 is concerned. Rules for ascertaining the profits of an enterprise of a Contracting State which is trading with an enterprise of the other Contracting State when both enterprises are members of the same group of enterprises or are under the same effective control are dealt with in Article 9.

2. It should perhaps be said at this point that neither Article is strikingly novel or particularly detailed. The question of what criteria should be used in attributing profits to a permanent establishment, and of how to allocate profits from transactions between enterprises under common control, has had to be dealt with in a large number of double taxation conventions and it is

fair to say that the solutions adopted have generally conformed to a standard pattern. It is generally recognized that the essential principles on which this standard pattern is based are well founded, and it has been thought sufficient to restate them with some slight amendments and modifications primarily aimed at producing greater clarity. The two Articles incorporate a number of directives. They do not, nor in the nature of things could they be expected to, lay down a series of precise rules for dealing with every kind of problem that may arise when an enterprise of one State makes profits in another. Modern commerce organises itself in an infinite variety of ways, and it would be quite impossible within the fairly narrow limits of an Article in a double taxation convention to specify an exhaustive set of rules for dealing with every kind of problem that may arise. This, however, is a matter of relatively minor importance, if there is agreement on general lines. [p. 73] Special cases may require special consideration, but it should not be difficult to find an appropriate solution if the problem is approached within the framework of satisfactory rules based on agreed principles.

II. Commentary on the Provisions of the Article

Paragraph 1

3. This paragraph is concerned with two questions. First, it restates the generally accepted principle of double taxation conventions that an enterprise of one State shall not be taxed in the other State unless it carries on business in that other State through a permanent establishment situated therein. It is hardly necessary to argue here the merits of this principle. It is perhaps sufficient to say that it has come to be accepted in international fiscal matters that until an enterprise of one State sets up a permanent establishment in another State it should not properly be regarded as participating in the economic life of that other State to such an extent that it comes within the jurisdiction of that other State's taxing rights.

4. The second and more important point is that it is laid down — in the second sentence — that when an enterprise carries on business through a permanent establishment in another State that

State may tax the profits of the enterprise but only so much of them as is attributable to the permanent establishment; in other words that the right to tax does not extend to profits that the enterprise may derive from that State otherwise than through the permanent establishment. This is a question on which there may be differences of view. Some countries have taken the view that when a foreign enterprise has set up a permanent establishment within their territory it has brought itself within their fiscal jurisdiction to such a degree that they can properly tax all profits that the enterprise derives from their territory, whether the profits come from the permanent establishment or from other activities in that territory. But it is thought that it is preferable to adopt the principle contained in the second sentence of paragraph 1, namely that the test that business profits should not be taxed unless there is a permanent establishment is one that should properly be applied not to the enterprise itself but to its profits. To put the matter another way, the principle laid down in the second sentence of paragraph 1 is based on the view that in taxing the profits that a foreign enterprise derives from a particular country, the fiscal authorities of that country should look at the separate sources of profit that the enterpise derives from their country and should apply to each the permanent establishment test. This is of course without prejudice to other Articles.

5. On this matter, naturally, there is room for differences of view, and since it is an important question it may be useful to set out the arguments for each point of view.

6. Apart from the background question of fiscal jurisdiction, the main argument commonly put forward against the solution advocated above is that there is a risk that it might facilitate avoidance of tax. This solution, the argument runs, might leave it open to an enterprise to set up in a particular country a permanent establishment which made no profits, was never intended to make profits, but existed solely to supervise a trade, perhaps of an extensive nature, that the enterprise carried on in that country through independent agents and the like. Moreover, the argument goes, although the whole of this trade might be directed [p. 74] and arranged by the permanent establishment, it might be difficult in practice to prove that that was the case. If the rates of tax

are higher in that country than they are in the country in which the head office is situated, then the enterprise has a strong incentive to see that it pays as little tax as possible in the other territory; the main criticism of the solution advocated above is that it might conceivably provide the enterprise with a means of ensuring that result.

7. Apart again from the question of the proper extent of fiscal jurisdiction, the main argument in favour of the proposed solution is that it is conducive to simple and efficient administration, and that it is more closely adapted to the way in which business is commonly transacted. The organisation of modern business is highly complex. In OECD Member countries, there are a considerable number of companies each of which is engaged in a wide diversity of activities and is carrying on business extensively in many countries. It may be that such a company may have set up a permanent establishment in a second country and may be transacting a considerable amount of business through that permanent establishment in one particular kind of manufacture; that a different part of the same company may be selling quite different goods or manufactures in that second country through independent agents; and that the company may have perfectly genuine reasons for taking this course — reasons based, for example, either on the historical pattern of its business or on commercial convenience. Is it desirable that the fiscal authorities should go so far as to insist on trying to search out the profit element of each of the transactions carried on through independent agents, with a view to aggregating that profit with the profits of the permanent establishment? Such an Article might interfere seriously with ordinary commercial processes, and so be out of keeping with the aims of the Convention.

8. It is no doubt true that evasion of tax could be practised by undisclosed channelling of profits away from a permanent establishment and that this may sometimes need to be watched, but it is necessary in considering this point to preserve a sense of proportion and to bear in mind what is said above. It is not, of course, sought in any way to sanction any such malpractice, or to shelter any concern thus evading tax from the consequences that would follow from detection by the fiscal authorities concerned. It

is fully recognised that Contracting States should be free to use all methods at their disposal to fight fiscal evasion.

9. For the reasons given above, it is thought that the argument that the solution advocated might lead to increased avoidance of tax by foreign enterprises should not be given undue weight. Much more importance is attached to the desirability of interfering as little as possible with existing business organisation and of refraining from inflicting demands for information on foreign enterprises which are unnecessarily onerous.

Paragraph 2

10. This paragraph contains the central directive on which the allocation of profits to a permanent establishment is intended to be based. The paragraph incorporates the view, which is generally contained in bilateral conventions, that the profits to be attributed to a permanent establishment are those which that permanent establishment would have made if, instead of dealing with its head office, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. Normally, these would be the same profits that one would expect to be determined by the ordinary processes [p. 75] of good business accountancy. This principle also extends to the allocation of profits which the permanent establishment may derive from transactions with other permanent establishments of the enterprise and with associated companies and their permanent establishments; but Contracting States which consider that the existing paragraph does not in fact cover these more general transactions may, in their bilateral negotiations, agree upon more detailed provisions.

11. In the great majority of cases, trading accounts of the permanent establishment — which are commonly available if only because a well-run business organisation is normally concerned to know what is the profitability of its various branches — will be used by the taxation authorities concerned to ascertain the profit properly attributable to that establishment. Exceptionally there may be no separate accounts (cf. paragraphs 23 to 27 below). But where there are such accounts they will naturally form the starting point for any processes of adjustment in case

adjustment is required to produce the amount of properly attributable profits. It should perhaps be emphasized that the directive contained in paragraph 2 is no justification for tax administrations to construct hypothetical profit figures in vacuo; it is always necessary to start with the real facts of the situation as they appear from the business records of the permanent establishment and to adjust as may be shown to be necessary the profit figures which those facts produce. It should also be noted that the principle set out in paragraph 2 is subject to the provisions contained in paragraph 3, especially as regards the treatment of payments which, under the name of interest, royalties, etc. are made by a permanent establishment to its head office in return for money loaned, or patent rights conceded by the latter to the permanent establishment (cf. paragraphs 16 below and following).

12. Even where a permanent establishment is able to produce proper accounts which purport to show the profits arising from its activities, it may still be necessary for the taxation authorities of the country concerned to rectify those accounts, in accordance with the general directive laid down in paragraph 2. Adjustment of this kind may be necessary, for example, because goods have been invoiced from the head office to the permanent establishment at prices which are not consistent with this directive, and profits have thus been diverted from the permanent establishment to the head office, or vice versa.

13. In such cases, it will usually be appropriate to substitute for the prices used ordinary market prices for the same or similar goods supplied on the same or similar conditions. Clearly the price at which goods can be bought on open market terms varies with the quantity required and the period over which they will be supplied; such factors would have to be taken into account in deciding the open market price to be used. It is perhaps only necessary to mention at this point that there may sometimes be perfectly good commercial reasons for an enterprise invoicing its goods at prices less than those prevailing in the ordinary market; this may, for example, be a perfectly normal commercial method of establishing a competitive position in a new market and should not then be taken as evidence of an attempt to divert profits from

one country to another. Difficulties may also occur in the case of proprietary goods produced by an enterprise, all of which are sold through its permanent establishments; if in such circumstances there is no open market price, and it is thought that the figures in the accounts are unsatisfactory, it may be necessary to calculate the permanent establishment's profits by other methods, for example, by applying an average ratio of gross profit to the turnover of the permanent establishment and then deducting [p. 76] from the figure so obtained the proper amount of expenses incurred. Clearly many special problems of this kind may arise in individual cases but the general rule should always be that the profits attributed to a permanent establishment should be based on that establishment's accounts insofar as accounts are available which represent the real facts of the situation. If available accounts do not represent the real facts then new accounts will have to be constructed, or the original ones rewritten, and for this purpose the figures to be used will be those prevailing in the open market.

14. Some States consider that there is a realisation of a taxable profit when an asset, other then trading stock, forming part of the business property of a permanent establishment situated within their territory is transferred to a permanent establishment or the head office of the same enterprise situated in another State. Article 7 allows such States to tax profits deemed to arise in connection with such a transfer. Such profits may be determined as indicated in paragraphs 10 to 13 above.

Paragraph 3

15. This paragraph clarifies, in relation to the expenses of a permanent establishment, the general directive laid down in paragraph 2. The paragraph specifically recognises that in calculating the profits of a permanent establishment allowance is to be made for expenses, wherever incurred, that were incurred for the purposes of the permanent establishment. Clearly in some cases it will be necessary to estimate or to calculate by conventional means the amount of expenses to be taken into account. In the case, for example, of general administrative expenses incurred at the head office of the enterprise, it may be appropriate to take into

account a proportionate part based on the ratio that the permanent establishment's turnover (or perhaps gross profits) bears to that of the enterprise as a whole. Subject to this, it is considered that the amount of expenses to be taken into account as incurred for the purposes of the permanent establishment should be the actual amount so incurred. The deduction allowable to the permanent establishment for any of the expenses of the enterprise attributed to it does not depend upon the actual reimbursement of such expenses by the permanent establishment.

16. Apart from what may be regarded as ordinary expenses, there are some classes of payments between permanent establishments and head offices which give rise to special problems, and it is convenient to deal with them at this point. The next paragraphs discuss three specific cases of this kind and give solutions for them. It should not, of course, be inferred that it is only in relation to the three classes of payments mentioned in these paragraphs that problems may arise; there may well be payments of other kinds to which similar considerations apply.

17. The first of these cases relates to payments which under the name of interest, royalties, etc. are made by a permanent establishment to its head office in return for money loaned, or patent rights conceded, by the latter to the permanent establishment. In such a case, it is considered that the payments should not be allowed as deductions in computing the permanent establishment's taxable profits. Equally, such payments made to a permanent establishment by the head office should be excluded from the computation of the permanent establishment's taxable profits. It is, however, recognised that special considerations apply to payments of interest made by different parts of a financial enterprise (e.g. a bank) to each other on advances etc. (as distinct from capital allotted to them), in view [p. 77] of the fact that making and receiving advances is narrowly related to the ordinary business of such enterprises. Furthermore, if an enterprise makes payments of interest, etc. to a third party and these payments in part relate to the activities of the permanent establishment, then a proportionate part of them should naturally be taken into account in calculating the permanent establishment's

profits insofar as they can properly be regarded as expenses incurred for the purposes of the permanent establishment.

18. The second case relates to the performance of ancillary services by a permanent establishment on behalf of its head office or vice versa. Consider, for example, the case of a large company with a varied business, part of which it carries on in another country through a permanent establishment. In addition, that permanent establishment advertises on behalf of its head office goods which that enterprise produces but which the permanent establishment itself does not handle. Clearly, in calculating for tax purposes the profits of the permanent establishment, the profits should be increased by the amount of the expense it has incurred on behalf of the head office (unless, of course, such an adjustment has already been made in drawing up the accounts of the permanent establishment). In fact if the permanent establishment and its head office were entirely separate and independent, the permanent establishment would ordinarily carry out services for the head office only if it were paid a commission as well as reimbursed the actual expenses incurred. It is, therefore, necessary to decide whether the calculation should be made on the basis of account being taken not only of any expenses borne by a permanent establishment by reason of services performed for the head office but also of a notional commission increasing the profits of the permanent establishment.

19. After consideration of this question, it is thought that in such circumstances the profits of the permanent establishment should not be increased by the addition of a "commission" figure. While, on one view, to include a "commission" figure in the profits of every permanent establishment that has performed services otherwise than for its own purposes could be looked at in theory as a consequential application of the fiction of separate enterprise, it would inevitably be found exceedingly cumbersome in practice. There would be scope for lengthy argument about, and usually no concrete basis for detemining, the percentage to be used in calculating the amount of notional "commission". In the great majority of cases the accounts of the permanent establishment would doubtless take into consideration actual expenses incurred; in other words they would not normally include any

credit for "commission". If as a general rule the "separate enterprise" test were to be applied to services performed by a permanent establishment on behalf of its head office and a notional "commission" profit were to be included in the profits of the permanent establishment, it would, therefore, be necessary in the great majority of cases first to settle how the "commission" element was to be calculated and then re-write the accounts of the permanent establishment. Considerations of practical administration weigh heavily against such a course. Therefore no "commission" element should in such cases be included in the profits of the permanent establishment. Similarly, in the converse case where the head office undertakes services on behalf of the permanent establishment, no "commission" element should be deducted in determining the profits of the permanent establishment.

20. The third case is related to the question whether any part of the total profits of an enterprise should be deemed to arise from the exercise of good [p. 78] management. Consider the case of a company that has its head office in one country but carries on all its business through a permanent establishment situated in another country. In the extreme case it might well be that only the directors' meetings were held at the head office and that all other activities of the company, apart from purely formal legal activities, were carried on in the permanent establishment. In such a case there is something to be said for the view that at least part of the profits of the whole enterprise arose from the skilfull management and business acumen of the directors and that part of the profits of the enterprise ought, therefore, to be attributed to the country in which the head office was situated. If the company has been managed by a managing agency, then that agency would doubtless have charged a fee for its services and the fee might well have been a simple percentage participation in the profits of the enterprise. But, once again, whatever the theoretical merits of such a course, practical considerations weigh heavily against it. In the kind of case quoted the expenses of management would, of course, be set against the profits of the permanent establishment in accordance with the provisions of paragraph 3, but when the matter is looked at as a whole, it is thought that it would not be right to go further by deducting and taking into account some

notional figure for "profits of management". In cases identical to the extreme case mentioned above, no account should therefore be taken in determining taxable profits of the permanent establishment of any notional figure such as profits of management.

21. It may be, of course, that countries where it has been customary to allocate some proportion of the total profits of an enterprise to the head office of the enterprise to represent the profits of good management will wish to continue to make such an allocation. Nothing in the Article is designed to prevent this. Nevertheless it follows from what is said in paragraph 20 above that a country in which a permanent establishment is situated is in no way required to deduct when calculating the profits attributable to that permanent establishment an amount intended to represent a proportionate part of the profits of management attributable to the head office.

22. It might well be that if the country in which the head office of an enterprise is situated allocates to the head office some percentage of the profits of the enterprise only in respect of good management, while the country in which the permanent establishment is situated does not, the resulting total of the amounts charged to tax in the two countries would be greater than it should be. In any such case the country in which the head office of the enterprise is situated should take the initiative in arranging for such adjustments to be made in computing the taxation liability in that country as may be necessary to ensure that any double taxation is eliminated.

23. It is usually found that there are, or there can be constructed, adequate accounts for each part or section of an enterprise so that profits and expenses, adjusted as may be necessary, can be allocated to a particular part of the enterprise with a considerable degree of precision. This method of allocation is, it is thought, to be preferred in general wherever it is reasonably practicable to adopt it. There are, however, circumstances in which this may not be the case and paragraphs 2 and 3 are in no way intended to imply that other methods cannot properly be adopted where appropriate in order to arrive at the profits of a permanent establishment on a "separate enterprise" footing. It may well be, for example, that profits of insurance enterprises can

most conveniently be ascertained by special methods of computation, e.g. by applying appropriate co-efficients to gross premiums received from policy holders in the country concerned. Again, [p. 79] in the case of a relatively small enterprise operating on both sides of the border between two countries, there may be no proper accounts for the permanent establishment nor means of constructing them. There may, too, be other cases where the affairs of the permanent establishment are so closely bound up with those of the head office that it would be impossible to disentangle them on any strict basis of branch accounts. Where it has been customary in such cases to estimate the arm's length profit of a permanent establishment by reference to suitable criteria, it may well be reasonable that that method should continue to be followed, notwithstanding that the estimate thus made may not achieve as high a degree of accurate measurement of the profit as adequate accounts. Even where such a course has not been customary, it may, exceptionally, be necessary for practical reasons to estimate the arm's length profits.

Paragraph 4

24. It has in some cases been the practice to determine the profits to be attributed to a permanent establishment not on the basis of separate accounts or by making an estimate of arm's length, but simply by apportioning the total profits of the enterprise by reference to various formulae. Such a method differs from those envisaged in paragraph 2, since it contemplates not an attribution of profits on a separate enterprise footing, but an apportionment of total profits; and indeed it might produce a result in figures which would differ from that which would be arrived at by a computation based on separate accounts. Paragraph 4 makes it clear that such a method may continue to be employed by a Contracting State if it has been customary in that State to adopt it, even though the figure arrived at may at times differ to some extent from that which would be obtained from separate accounts, provided that the result can fairly be said to be in accordance with the principles contained in the Article. It is emphasized, however, that in general the profits to be attributed to a permanent establishment should be determined by reference to the establishment's accounts if these reflect the real facts. It is

considered that a method of allocation which is based on apportioning total profits is generally not as appropriate as a method which has regard only to the activities of the permanent establishment and should be used only where, exceptionally, it has as a matter of history been customary in the past and is accepted in the country concerned both by the taxation authorities and taxpayers generally there as being satisfactory. It is understood that paragraph 4 may be deleted where neither State uses such a method. Where, however, Contracting States wish to be able to use a method which has not been customary in the past the paragraph should be amended during the bilateral negotiations to make this clear.

25. It would not, it is thought, be appropriate within the framework of this Commentary to attempt to discuss at length the many various methods involving apportionment of total profits that have been adopted in particular fields for allocating profits. These methods have been well documented in treatises on international taxation. It may, however, not be out of place to summarise briefly some of the main types and to lay down some very general directives for their use.

26. The essential character of a method involving apportionment of total profits is that a proportionate part of the profits of the whole enterprise is allocated to a part thereof, all parts of the enterprise being assumed to have contributed on the basis of the criterion or criteria adopted to the profitability of the whole. [p. 80] The difference between one such method and another arises for the most part from the varying criteria used to determine what is the correct proportion of the total profits. It is fair to say that the criteria commonly used can be grouped into three main categories, namely those which are based on the receipts of the enterprise, its expenses or its capital structure. The first category covers allocation methods based on turnover or on commission, the second on wages and the third on the proportion of the total working capital of the enterprise allocated to each branch or part. It is not, of course, possible to say in vacuo that any of these methods is intrinsically more accurate than the others; the appropriateness of any particular method will depend on the circumstances to which it is applied. In some enterprises,

such as those providing services or producing proprietary articles with a high profit margin, net profits will depend very much on turnover. For insurance enterprises it may be appropriate to make an apportionment of total profits by reference to premiums received from policy holders in each of the countries concerned. In the case of an enterprise manufacturing goods with a high cost raw material or labour content, profits may be found to be related more closely to expenses. In the case of banking and financial concerns the proportion of total working capital may be the most relevant criterion. It is considered that the general aim of any method involving apportionment of total profits ought to be to produce figures of taxable profit that approximate as closely as possible to the figures that would have been produced on a separate accounts basis, and that it would not be desirable to attempt in this connection to lay down any specific directive other than that it should be the responsibility of the taxation authority, in consultation with the authorities of other countries concerned, to use the method which in the light of all the known facts seems most likely to produce that result.

27. The use of any method which allocates to a part of an enterprise a proportion of the total profits of the whole does, of course, raise the question of the method to be used in computing the total profits of the enterprise. This may well be a matter which will be treated differently under the laws of different countries. This is not a problem which it would seem practicable to attempt to resolve by laying down any rigid rule. It is scarcely to be expected that it would be accepted that the profits to be apportioned should be the profits as they are computed under the laws of one particular country; each country concerned would have to be given the right to compute the profits according to the provisions of its own laws.

Paragraph 5

28. In paragraph 4 of Article 5 there are listed a number of examples of activities which, even though carried on at a fixed place of business, are deemed not to be included in the term "permanent establishment." In considering rules for the allocation of profits to a permanent establishment the most important of

these examples is the activity mentioned in paragraph 5 of this Article, i.e. the purchasing office.

29. Paragraph 5 is not, of course, concerned with the organisation established solely for purchasing; such an organization is not a permanent establishment and the profits allocation provisions of this Article would not therefore come into play. The paragraph is concerned with a permanent establishment which although carrying on other business also carries on purchasing for its head office. In such a case the paragraph provides that the profits of the permanent establishment shall not be increased by adding to them a notional figure for profits from purchasing. It follows, of course, that any expenses that arise from the purchasing activities [p. 81] will also be excluded in calculating the taxable profits of the permanent establishment.

Paragraph 6

30. This paragraph is intended to lay down clearly that a method of allocation once used should not be changed merely because in a particular year some other method produces more favourable results. One of the purposes of a double taxation convention is to give an enterprise of a Contracting State some degree of certainty about the tax treatment that will be accorded to its permanent establishment in the other Contracting State as well as to the part of it in its home State which is dealing with the permanent establishment; for this reason, paragraph 6 gives an assurance of continuous and consistent tax treatment.

Paragraph 7

31. Although it has not been found necessary in the Convention to define the term "profits," it should nevertheless be understood that the term when used in this Article and elsewhere in the Convention has a broad meaning including all income derived in carrying on an enterprise. Such a broad meaning corresponds to the use of the term made in the tax laws of most OECD Member countries.

32. This interpretation of the term "profits," however, may give rise to some uncertainty as to the application of the Conven-

tion. If the profits of an enterprise include categories of income which are treated separately in other Articles of the Convention, e.g. dividends, it may be asked whether the taxation of those profits is governed by the special Article on dividends etc., or by the provisions of this Article.

33. To the extent that an application of this Article and the special Article concerned would result in the same tax treatment, there is little practical significance to this question. Further, it should be noticed that some of the special Articles contain specific provisions giving priority to a specific Article (cf. paragraph 4 of Article 6, paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12, and paragraph 2 of Article 21).

34. It has seemed desirable, however, to lay down a rule of interpretation in order to clarify the field of application of the present Article in relation to the other Articles dealing with a specific category of income. In conformity with the practice generally adhered to in existing bilateral conventions, paragraph 7 gives first preference to the special Articles on dividends, interest etc. It follows from the rule that this Article will be applicable to industrial and commercial income which does not belong to categories of income covered by the special Articles, and, in addition, to dividends, interest etc. which under paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12 and paragraph 2 of Article 21, fall within this Article. It is understood that the items of income covered by the special Articles may, subject to the provisions of the Convention, be taxed either separately, or as industrial and commercial profits, in conformity with the tax laws of the Contracting States.

35. It is open to Contracting States to agree bilaterally upon special explanations or definitions concerning the term "profits" with a view to clarifying the distinction between this term and e.g. the concept of dividends. It may in particular be found appropriate to do so where in a convention under negotiation a deviation has been made from the definitions in the special Articles on dividends, interest [p. 82] and royalties. It may also be deemed desirable if the Contracting States wish to place on notice, that, in agreement with the domestic tax laws of one or both of the States, the term "profits" includes special classes of receipts such as

income from the alienation of the letting of a business or of movable property used in a business. In this connnection it may have to be considered whether it would be useful to include also additional rules for the allocation of such special profits.

Observations on the Commentary

36. *Australia* and *New Zealand* would wish to be free to propose in bilateral negotiations a provision to the effect that, if the information available to the competent authority of a Contracting State is inadequate to determine the profits to be attributed to the permanent establishment of an enterprise, the competent authority may apply to that enterprise for that purpose the provisions of the taxation law of that State, subject to the qualification that such law will be applied, so far as the information available to the competent authority permits, in accordance with the principles of this Article.

37. *Australia* would wish that in this Article there be provision that will permit resort to domestic law in relation to the taxation of the profit of an insurance enterprise.

38. While *New Zealand,* for the purpose of negotiating conventions with other Member countries, accepts, in general, the principles of this Article relating to the attribution of profits to a permanent establishment, it would wish to be free to negotiate for the inclusion of specific provision governing the basis of attribution in some particular situations.

Reservations on the Article

39. *New Zealand* reserves the right to exclude from the scope of this Article income from the business of any form of issuance.

40. The *United States* believes it appropriate to provide in paragraph 2 for arm's length treatment not only with the head office of the enterprise, but also with any person controlling, controlled by, or subject to the same common control as, the enterprise. This can be accomplished by changing the phrase "separate enterprise" to "independent enterprise" and by deleting the last fourteen words.

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[p. 88] COMMENTARY ON ARTICLE 9 CONCERNING THE TAXATION OF ASSOCIATED ENTERPRISES

Paragraph 1

1. This Article deals with associated enterprises (parent and subsidiary companies and companies under common control) and its paragraph 1 provides that in such cases the taxation authorities of a Contracting State may for the purpose of calculating tax liabilities re-write the accounts of the enterprises if as a result of the special relations between the enterprises the accounts do not show the true taxable profits arising in that State. It is evidently appropriate that adjustment should be sanctioned in such circumstances, and this paragraph seems to call for very little comment. It should perhaps be mentioned that the provisions of this paragraph apply only if special conditions have been made or imposed between the two enterprises. No re-writing of the accounts of associated enterprises is authorised if the transactions between such enterprises have taken place on normal open market commercial terms (on an arm's length basis).

Paragraph 2

2. The re-writing of transactions between associated enterprises in the situation envisaged in paragraph 1 may give rise to economic double taxation (taxation of the same income in the hands of different persons), insofar as an enterprise of State A whose profits are revised upwards will be liable to tax on an amount of profit which has already been taxed in the hands of its associated enterprise in State B. Paragraph 2 provides that in these circumstances, State B shall make an appropriate adjustment so as to relieve the double taxation.

3. It should be noted, however, that an adjustment is not automatically to be made in State B simply because the profits in State A have been increased; the adjustment is due only if State B considers that the figure of adjusted profits correctly reflects what the profits would have been if the transactions had been at arm's length. In other words, the paragraph does not seek to avoid a double charge to tax which arises where the profits of one

associated enterprise are increased to a level which exceeds what they would have been if they had been correctly computed on an arm's length basis. State **B** is therefore committed to make an adjustment of the profits of the affiliated company only if it considers that the adjustment made in State A is justified both in principle and as regards the amount.

4. The paragraph does not specify the method by which an adjustment is to be made. OECD Member countries use different methods to provide relief in these circumstances and it is therefore left open for Contracting States to agree bilaterally on any specific rules which they wish to add to the Article. Some States, for example, would prefer the system under which, where the profits of enterprise X in State A are increased to what they would have been on an arm's [p. 89] length basis, the adjustment would be made by re-opening the assessment on the associated enterprise Y in State **B** containing the doubly taxed profits in order to reduce the taxable profit by an appropriate amount. Some other States, on the other hand, would prefer to provide that, for the purposes of Article 23, the doubly taxed profits should be treated in the hands of enterprise Y of State **B** as if they may be taxed in State A; accordingly, the enterprise of State **B** is entitled to relief in State **B**, under Article 23; in respect of tax paid by its associate enterprise in State A.

5. It is not the purpose of the paragraph to deal with what might be called "secondary adjustments". Suppose that an upward revision of taxable profits of enterprise X in State A has been made in accordance with the principle laid down in paragraph 1; and suppose also that an adjustment is made to the profits of enterprise Y in State **B** in accordance with the principle laid down in paragraph 2. The position has still not been restored exactly to what it would have been had the transactions taken place at arm's length prices because, as a matter of fact, the money representing the profits which are the subject of the adjustment is found in the hands of enterprise Y instead of in those of enterprise X. It can be argued that if arm's length pricing had operated and enterprise X had subsequently wished to transfer these profits to enterprise Y, it would have done so in the form of, for example, a dividend or a royalty (if enterprise Y were the parent of enterprise X) or in the form of, for example, a loan (if enterprise X were the parent of enterprise Y); and that in those circumstances there could have been other tax consequences (e.g. the operation of a withholding tax) depending upon the type of income concerned and the provisions of the Article dealing with such income.

6. These secondary adjustments, which would be required to establish the situation exactly as it would have been if transactions had been at arm's length, depend on the facts of the individual case. It should be noted that nothing in paragraph 2 prevents such secondary adjustments from being made where they are permitted under the domestic laws of Contracting States.

7. The paragraph also leaves open the question whether there should be a period of time after the expiration of which State **B** would not be obliged to make an appropriate adjustment to the profits of enterprise Y following an upward revision of the profits of enterprise X in State A. Some States consider that State **B**'s commitment should be open-ended—in other words, that however many years State A goes back to revise assessments, enterprise Y should in equity be assured of an appropriate adjustment in State **B**. Other States consider that an open-ended commitment of this sort is unreasonable as a matter of practical administration. In the circumstances, therefore, this problem has not been dealt with in the text of the Article; but Contracting States are left free in bilateral conventions to include, if they wish, provisions dealing with the length of time during which State **B** is to be under obligation to make an appropriate adjustment.

8. If there is a dispute between the interested parties over the character and amount of the appropriate adjustment, the matter will be dealt with in the same way as any other question of fact; if necessary the competent authorities may consult each other.

Observations of the Commentary

9. In negotiating conventions with other Member countries, *Australia* and *New Zealand* would wish to be free to propose a provision to the effect that, if [p. 90] the information available to the competent authority of a Contracting State is inadequate to

determine the profits to be attributed to an enterprise, the competent authority may apply to that enterprise for that purpose the provisions of the taxation law of that State, subject to the qualification that such law will be applied, as far as the information available to the competent authority permits, in accordance with the principles of this Article.

10. *Australia* would wish that, in this Article, there be provision that will permit resort to domestic law in relation to the taxation of the profits of an insurance enterprise.

Reservations on the Article

11. *Belgium, Finland, Germany, Italy, Japan, Portugal* and *Switzerland* reserve the right not to insert paragraph 2 in their conventions.

12. The *United States* believes that this Article should apply to all related persons, not just an enterprise of one Contracting State and a related enterprise of the other Contracting State, and that it should apply to "income, deductions, credits or allowances," not just to "profits."

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[p. 162] COMMENTARY ON ARTICLE 24 CONCERNING NON-DISCRIMINATION

Paragraph 1

1. This paragraph establishes the principle that for purposes of taxation discrimination on the grounds of nationality is forbidden, and that, subject to reciprocity, the nationals of a Contracting State may not be less favourably treated in the other Contracting State than nationals of the latter State in the same circumstances.

2. It is noteworthy that the principle of non-discrimination, under various descriptions and with a more or less wide scope, was applied in international fiscal relations well before the appearance, at the end of the 19th Century, of the classic type of double taxation conventions. Thus, in a great many agreements of different kinds (consular or establishment conventions, treaties of

friendship or commerce, etc.) concluded by States, especially in the 19th Century, in order to extend and strengthen the diplomatic protection of their nationals wherever resident, there are clauses under which each of the two Contracting States undertakes to accord nationals of the other State equality of treatment with its own nationals. The fact that such clauses subsequently found their way into double taxation conventions has in no way affected their original justification and scope. The text of paragraph 1 provides that the application of this paragraph is not restricted by Article 1 to nationals solely who are residents of a Contracting State, but on the contrary, extends to all nationals of each Contracting State, whether or not they be residents of one of them. In other words, all nationals of a Contracting State are entitled to invoke the benefit of this provision as against the other Contracting State. This holds good, in particular, for nationals of the Contracting States who are not residents of either of them but of a third State.

3. The expression "in the same circumstances" refers to taxpayers (individuals, legal persons, partnerships and associations) placed, from the point of view of the application of the ordinary taxation laws and regulations, in substantially similar circumstances both in law and in fact.

4. Consequently if a Contracting State, in giving relief from taxation on account of family responsibilities, distinguishes between its own nationals according to whether they reside in its territory or not, that State cannot be obliged to give nationals of the other State who do not reside in its territory the same treatment as it gives its resident nationals but it undertakes to exend to them the same treatment as is available to its non-resident nationals.

5. Likewise, the provisions of paragraph 1 are not to be construed as obliging a State which accords special taxation privileges to its own public bodies or services as such, to extend the same privileges to the public bodies and services of the other State.

[p. 163] 6. Neither are they to be construed as obliging a State which accords special taxation privileges to private institu-

tions not for profit whose activities are performed for purposes of public benefit, which are specific to that State, to extend the same privileges to similar institutions whose activities are not for its benefit.

7. To take the first of these two cases, if a State accords immunity from taxation to its own public bodies and services, this is justified because such bodies and services are integral parts of the State and at no time can their circumstances be comparable to those of the pubic bodies and services of the other State. Nevertheless, this reservation is not intended to apply to State corporations carrying on gainful undertakings. To the extent that these can be regarded as being on the same footing as private industrial and commercial undertakings, the provisions of paragraph 1 will apply to them.

8. As for the second case, if a State accords taxation privileges to certain private institutions not for profit, this is clearly justified by the very nature of these institutions' activities and by the benefit which that State and its nationals will derive from those activities.

9. Furthermore, paragraph 1 has been deliberately framed in a negative form. By providing that the nationals of a Contracting State may not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of the other Contracting State in the same circumstances are or may be subjected, this paragraph has the same mandatory force as if it enjoined the Contracting States to accord the same treatment to their respective nationals. But since the principal object of this clause is to forbid discrimination in one State against the nationals of the other, there is nothing to prevent the first State from granting to persons of foreign nationality, for special reasons of its own, or in order to comply with a special stipulation in a double taxation convention, such as, notably, the requirement that profits of permanent establishments are to be taxed on the basis of separate accounts, certain concessions or facilities which are not available to its own nationals. As it is worded, paragraph 1 would not prohibit this.

10. Subject to the foregoing observation, the words "... shall not be subjected ... to any taxation or any requirement connected therewith which is other or more burdensome ..." mean that when a tax is imposed on nationals and foreigners in the same circumstances, it must be in the same form as regards both the basis of charge and the method of assessment, its rate must be the same, and, finally, the formalities connected with the taxation (returns, payment, prescribed times, etc.) must not be more onerous for foreigners than for nationals.

Paragraph 2

11. Paragraph 2 merely stipulates that the term "nationals" applies to all individuals possessing the nationality of a Contracting State. It has not been judged necessary here to introduce into the text of the Article any considerations on the signification of the concept of nationality, any more than it seemed indispensable to make any special comment here on the meaning and application of the word. Obviously, in determining in relation to individuals, what is meant by "the nationals of a Contracting State," reference must be made to the sense in which the term is usually employed and each State's particular rules on the acquisition or loss of nationality.

[p. 164] 12. But paragraph 2 is more specific as to legal persons, partnerships and associations. By declaring that all legal persons, partnerships and associations deriving their status as such from the laws in force in a Contracting State are considered to be nationals for the purposes of paragraph 1, the provision disposes of a difficulty which often arises in determining the nationality of companies. In defining the nationality of companies, certain States have regard less to the law which governs the company than to the origin of the capital with which the company was formed or the nationality of the individuals or legal persons controlling it.

13. Moreover, in view of the legal relationship created between the company and the State under whose law it is constituted, which from certain points of view is closely akin to the relationship of nationality in the case of individuals, it seems justifiable not to deal with legal persons, partnerships and associa-

tions in a special provision, but to assimilate them with individuals under the term "nationals".

Paragraph 3

14. On 28th September, 1954, a number of States concluded in New York a Convention relating to the status of stateless persons, under Article 29 of which stateless persons must be accorded national treatment. The signatories of the Convention include several OECD Member countries.

15. It should, however, be recognised that the provisions of paragraph 3 will, in a bilateral convention, enable national treatment to be extended to stateless persons who, because they are in one of the situations enumerated in paragraph 2 of Article 1 of the above-mentioned Convention of 28th September, 1954, are not covered by that Convention. This is mainly the case, on the one hand, of persons receiving at the time of signature of that Convention, protection or assistance from organs or agencies of the United Nations other than the United Nations High Commissioner for Refugees, and, on the other hand, of persons who are residents of a country and who there enjoy and are subject to the rights and obligations attaching to the possession of that country's nationality.

16. The purpose of paragraph 3 is to limit the scope of the clause concerning equality of treatment with nationals of a Contracting State solely to stateless persons who are residents of that of the other Contracting State.

17. By thus excluding stateless persons who are residents of neither Contracting State, such a clause prevents their being privileged in one State as compared with nationals of the other State.

18. However, if States were to consider it desirable in their bilateral relations, to extend the application of paragraph 3 to all stateless persons, whether residents of a Contracting State or not, so that in all cases they enjoy the most favourable treatment accorded to nationals of the State concerned, in order to do this they would need only to adopt the following text which contains no condition as to residence in a Contracting State:

"Notwithstanding the provisions of Article 1, stateless persons shall not be subjected in a Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that State in the same circumstances are or may be subjected."

[p. 165] 19. It is possible that in the future certain States will take exception to the provisions of paragraph 3 as being too liberal insofar as they entitle stateless persons who are residents of one State to claim equality of treatment not only in the other State but also in their State of residence and thus benefit in particular in the latter from the provisions of double taxation conventions concluded by it with third States. If such States wished to avoid this latter consequence, they would have to modify paragraph 3 as follows:

"Stateless persons who are residents of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected."

20. Finally, it should be understood that the definition of the term "stateless person" to be used for the purposes of such a clause can only be that laid down in paragraph 1 of Article 1 of the Convention of 28th September, 1954, which defines a stateless person as "a person who is not considered as a national by any State under the operation of its law".

Paragraph 4

21. Strictly speaking, the type of discrimination which this paragraph is designed to end is discrimination based not on nationality but on the actual situs of an enterprise. It therefore affects without distinction, and irrespective of their nationality, all residents of a Contracting State who have a permanent establishment in the other Contracting State.

22. It appears necessary first to make it clear that the wording of the first sentence of paragraph 4 must be interpreted in the

sense that it does not constitute discrimination to tax non-resident persons differently, for practical reasons, from resident persons, as long as this does not result in more burdensome taxation for the former than for the latter. In the negative form in which the provision concerned has been framed, it is the result alone which counts, it being permissable to adapt the mode of taxation to the particular circumstances in which the taxation is levied.

23. By the terms of the first sentence of paragraph 4, the taxation of a permanent establishment shall not be less favourably levied in the State concerned than the taxation levied on enterprises of that State carrying on the same activities. The purpose of this provision is to end all discrimination in the treatment of permanent establishments as compared with resident enterprises belonging to the same sector of activities, as regards taxes based on industrial and commercial activities, and especially taxes on business profits.

24. However, the second sentence of paragraph 4 specifies the conditions under which the principle of equal treatment set forth in the first sentence should be applied to individuals who are residents of a Contracting State and have a permanent establishment in the other State. It is designed mainly to ensure that such persons do not obtain greater advantages than residents, through entitlement to personal allowances and reliefs for family responsibilities, both in the State of which they are residents, by the application of its domestic laws, and in the other State by virtue of the principle of equal treatment. Consequently, it leaves it open to the State in which the permanent establishment is situated whether or not to give personal allowances and reliefs to the person [p. 166] concerned in the proportion which the amount of the permanent establishment's profits bears to the world income taxable in the other State.

25. As regards the first sentence, experience has shown that it was difficult to define clearly and completely the substance of the principle of equal treatment and this has led to wide differences of opinion with regard to the many implications of this principle. The main reason for difficulty seems to reside in the actual nature of the permanent establishment, which is not a separate legal entity but only a part of an enterprise that has its head office in

another State. The situation of the permanent establishment is different from that of a domestic enterprise, which constitutes a single entity all of whose activities, with their fiscal implications, can be fully brought within the purview of the State where it has its head office. The implications of the equal treatment clause will be examined below under several aspects of the levying of tax.

A. Assessment of Tax

26. With regard to the basis of assessment of tax, the principle of equal treatment normally has the following implications:

a) Permanent establishments must be accorded the same right as resident enterprises to deduct the trading expenses that are, in general, authorised by the taxation law to be deducted from taxable profits in addition to the right to attribute to the permanent establishment a proportion of the overheads of the head office of the enterprise. Such deductions should be allowed without any restrictions other than those also imposed on resident enterprises.

b) Permanent establishments must be accorded the same facilities with regard to depreciation and reserves. They should be entitled to avail themselves without restriction not only of the depreciation facilities which are customarily available to enterprises (straight line depreciation, declining balance depreciation), but also of the special systems that exist in a number of countries ("wholesale" writing down, accelerated depreciation, etc.). As regards reserves, it should be noted that these are sometimes authorised for purposes other than the offsetting—in accordance with commerical accounting principles—of depreciation on assets, expenses or losses which have not yet occurred but which circumstances make likely to occur in the near future. Thus, in certain countries, enterprises are entitled to set aside, out of taxable profit, provisions or "reserves" for investment. When such a right is enjoyed by all enterprises, or by all enterprises in a given sector of activity, it should normally also be enjoyed, under the same conditions, by non-resident enterprises, or by enterprises in a given sector of activity, it should in the State concerned, insofar, that is,

as the activities to which such provisions or reserves would pertain are taxable in that State.

c) Permanent establishments should also have the option that is available in most countries to resident enterprises of carrying forward or backward a loss brought out at the close of an accounting period with a certain period of time (e.g. 5 years). It is hardly necessary to specify that in the case of permanent establishments it is the loss on their own business activities, as shown in the separate accounts for these activities, which will qualify for such carry-forward.

d) Permanent establishments should further have the same rules applied [p. 167] to resident enterprises, with regard to the taxation of capital gains realised on the alienation of assets, whether during or on the cessation of business.

27. Although the general rules mentioned above rarely give rise to any difficulties with regard to the principle of non-discrimination, the same does not always hold good for the tax incentive measures which most countries, faced with such problems as decentralisation of industry, development of economically backward regions, or the promotion of new activities necessary for the expansion of the economy, have introduced in order to facilitate the solution of these problems by means of tax exemptions, reductions or other tax advantages given to enterprises for investment which is in line with official objectives.

28. As such measures are in furtherance of objectives directly related to the economic activity proper of the State concerned, it is right that the benefit of them should be extended to permanent establishments of enterprises of another State which has a double taxation convention with the first embodying the provisions of Article 24, once they have been accorded the right to engage in industrial or commercial activity in that State, either under its legislation or under an international agreement (treaties of commerce, establishment conventions, etc.) concluded between the two States.

29. It should, however, be noted that although non-resident enterprises are entitled to claim these tax advantages in the State concerned, they must fulfil the same conditions and requirements

as resident enterprises. They may, therefore, be denied such advantages if their permanent establishments are unable or refuse to fulfil the special conditions and requirements attached to the granting of them.

30. Finally, it goes without saying that non-resident enterprises are not entitled to tax advantages attaching to activities the exercise of which is strictly reserved, on grounds of national interest, defence, protection of the national economy, etc., to domestic enterprises, since non-resident enterprises are not allowed to engage in such activities.

B. Special Treatment of Dividends Received in Respect of Holdings Owned by Permanent Establishments

31. In many countries special rules exist for the taxation of dividends distributed between companies (parent company-subsidiary treatment, the "Schachtelprivileg", the rule "non bis in idem"). The question arises whether such treatment should by effect of the provisions of paragraph 4 also be enjoyed by permanent establishments in respect of dividends on holdings forming part of their assets.

32. On this point opinions differ. Some States consider that such special treatment should be accorded to permanent establishments. They take the view that such treatment was enacted in order to avoid double taxation on profits made by a subsidiary and distributed to a parent company. In principle profits tax should be levied once, in the hands of the subsidiary performing the profit-generating activities. The parent company should be exempted from tax on such profits when received from the subsidiary or should, under the indirect credit method, be given relief for the taxation borne by the subsidiary. In cases where shares are held as direct investment by a permanent establishment the same principle implies that such a permanent establishment receiving dividends [p. 168] from the subsidiary should likewise be granted the special treatment in view of the fact that a profits tax has already been levied in the hands of the subsidiary. On the other hand, it is hardly conceivable on this line of thought to leave it to the State where the head office of the parent company is situated to give

relief from double taxation brought about by a second levying of tax in the State of the permanent establishment. The State of the parent company, in which no activities giving rise to the doubly taxed profits have taken place, will normally exempt the profits in question or will levy a profits tax which is not sufficient to bear a double credit (i.e. for the profits tax on the subsidiary as well as for such tax on the permanent establishment). All this assumes that the shares held by the permanent establishment are effectively connected with its activity. Furthermore, an obvious additional condition is that the profits out of which the dividends are distributed should have borne a profits tax.

33. Other States, on the contrary, consider that assimilating permanent establishments to their own enterprises does not entail any obligation to accord such special treatment to the former. They justify their position on various grounds. The purpose of such special treatment is to avoid economic double taxation of dividends and it should be for the recipient company's State of residence and not the permanent establishment's State to bear its cost, because it is more interested in the aim in view. Another reason put forward related to the sharing of tax revenue between States. The loss of tax revenue incurred by a State in applying such special treatment is partly offset by the taxation of the dividends when they are redistributed by the parent company which has enjoyed such treatment (withholding tax on dividends, shareholder's tax). A State which accorded such treatment to permanent establishments would not have the benefit of such a compensation. Another argument made is that when such treatment is made conditional upon redistribution of the dividends its extension to permanent establishments would not be justified, for in such a case the permanent establishment, which is only a part of a company of another State and does not distribute dividends, would be more favourably treated than a resident company. Finally, the States which feel that paragraph 4 does not entail any obligation to extend such treatment to permanent establishments argue that there is a risk that companies of one State might transfer their holdings in companies of another State to their permanent establishments in that other State for the sole purpose of availing themselves of such treatment.

34. The fact remains that there can be very valid reasons for a holding being owned and managed by a permanent establishment rather than by the head office of the enterprise, viz.,

— reasons of necessity arising principally from a legal or regulatory obligation on banks and financial institutions and insurance companies to keep deposited in countries where they operate a certain amount of assets, particularly shares, as security for the performance of their obligations;

— or reasons of expediency, where the holdings are in companies which have business relations with the permanent establishment or whose head offices are situated in the same country as the permanent establishment;

— or simple reasons of practical convenience, in line with the present tendency towards decentralisation of management functions in large enterprises.

[p. 169] 35. In view of these divergent attitudes, as well as of the existence of the situations just described, it would be advisable for States, when concluding bilateral conventions, to make clear the interpretation they give to the first sentence of paragraph 4. They can, if they so desire, explain their position, or change it as compared with their previous practice, in a protocol or any other document annexed to the convention.

36. A solution could also be provided in such a document to meet the objection mentioned above that the extension of the treatment of holdings in a State (A) to permanent establishments of companies which are residents of another State (B) results in such companies unduly enjoying privileged treatment as compared with other companies which are residents of the same State and whose head offices own holdings in the capital of companies which are residents of State A, in that whereas the dividends on their holdings can be repatriated by the former companies without bearing withholding tax, such tax is levied on dividends distributed to the latter companies at the rate of 5 or 15 per cent as the case may be. Tax neutrality and the equality of tax burdens as between permanent establishments and subsidiary companies, as advocated by the States concerned, could be ensured by adapting, in the bilateral convention between States A and B, the provisions

of paragraphs 2 and 4 of Article 10, so as to enable withholding tax to be levied in State A on dividends paid by companies which are residents of that State to permanent establishments of companies which are residents of State B in the same way as if they are received directly i.e. by the head offices of the latter companies, viz., at the rate of:

— 5 per cent in the case of a holding of at least 25 per cent;

— 15 per cent in all other cases.

37. Should it not be possible, because of the absence of appropriate provisions in the domestic laws of the State concerned to levy a withholding tax there on dividends paid to permanent establishments, the treatment of inter-company dividends could be extended to permanent establishments, as long as its application is limited in such manner that the tax levied by the State of source of the dividends is the same whether the dividends are received by a permanent establishment of a company which is a resident of the other State or are received directly by such a company.

C. Structure and Rate of Tax

38. In countries where enterprises, mainly companies, are charged a tax on their profits which is specific to them, the provisions of paragraph 4 raise, with regard to the rate applicable in the case of permanent establishments, especially difficult and delicate problems, which here too arise from the fact that the permanent establishment is only a part of a legal entity which is not under the jurisdiction of the State where the permanent establishment is situated.

39. When the taxation of profits made by companies which are residents of a given State is calculated according to a progressive scale of rates, such a scale should, in principle, be applied to permanent establishments situated in that State. If in applying the progressive scale, the permanent establishment's State takes into account the profits of the whole company to which such a permanent establishment belongs, such a rule would not appear to conflict with the equal treatment rule, since resident companies are in fact treated in the same way (cf. paragraphs 55, 56 and 77

of the Commentary on Articles 23A and 23B). States [p. 170] that tax their own companies in this way could therefore define in their bilateral conventions the treatment applicable to permanent establishments.

40. When a system of taxation based on a progressive scale of rates includes a rule that a minimum rate is applicable to permanent establishments, it cannot be claimed a priori that such a rule is incompatible with the equal treatment principle. The profits of the whole enterprise to which the permanent establishment belongs should be taken into account in determining the rate applicable according to the progressive scale. The provisions of the first sentence of paragraph 4 are not observed only if the minimum rate is higher.

41. However, even if the profits of the whole enterprise to which the permanent establishment belongs is taken into account when applying either a progressive scale of rates or a minimum rate, this should not conflict with the principle of the distinct and separate enterprise, according to which the profits of the permanent establishment must be determined under paragraph 2 of Article 7. The minimum amount of the tax levied in the State where the permanent establishment is situated is, therefore, the amount which would be due if it were a distinct and separate enterprise, without reference to the profits of the whole enterprise to which it belongs. The State where the permanent establishment is situated is, therefore, justified in applying the progressive scale applicable to resident enterprises solely to the profits of the permanent establishment, leaving aside the profits of the whole enterprise when the latter are less than those of the permanent establishment. This State may likewise tax the profits of the permanent establishment at a minimum rate, provided that the same rate applies also to resident enterprises, even if taking into account the profits of the whole enterprise to which it belongs would result in a lower amount of tax, or no tax at all.

42. As regards the split-rate system of company tax, it should first be pointed out as being a fact central to the issue here that most OECD Member countries which have adopted this system do not consider themselves bound by the provisions of paragraph 4 to extend it to permanent establishments of non-resident com-

panies. This attitude is based, in particular, on the view that the split-rate is only one element amongst others (in particular a withholding tax on distributed income) in a system of taxing company profits and dividends which must be considered as a whole and is therefore, both for legal and technical reasons, of domestic application only. The State where the permanent establishment is situated could claim the right not to tax such profits at the reduced rate as, generally, it does not tax the dividends distributed by the company to which the permanent establishment belongs. Moreover, a State which has adopted a split-rate system usually has other economic policy objectives, such as the promotion of the capital market, by encouraging resident companies to distribute dividends. The extension of the reduced rate to the profits of the permanent establishment would not serve such a purpose at all, as the company distributing the dividends is not a resident of the State concerned.

43. This view is, however, disputed. The States in favour of extending the split-rate system to permanent establishments urge that as the essential feature of this system is a special technique of taxing profits which enterprises in a corporate form derive from their activities, and is designed to afford immediate relief from the double taxation levied on the profits distributed, it should be applied to permanent establishments in bilateral conventions against double taxation. It is generally recognised that, by the effects of their provisions, such [p. 171] conventions necessarily result in some integration of the taxation systems of the Contracting States. On this account, it is perfectly conceivable that profits made in a State (A) by a permanent establishment of a company resident in another State (B) should be taxed in State A according to the split-rate system. As a practical rule, the tax could in such case be calculated at the reduced rate (applicable to distributed profits) on that proportion of an establishment's profits which corresponds to the ratio between the profit distributed by the company to which it belongs and the latter's total profit; the remaining profit could be taxed at the higher rate. Of course, the two Contracting States would have to consult together and exchange all information necessary for giving practical effect to this solution. Similar considerations apply to systems where

distributions of profits made can be deducted from the taxable income of a company.

44. As regards the imputation system ("avoir fiscal" or "tax credit"), it seems doubtful, at least on a literal interpretation of the provisions of paragraph 4, whether it should be extended to non-resident companies in respect of dividends paid out of profits made by their permanent establishments. In fact, it has identical effects to those of the split-rate system but these effects are not immediate as they occur only at the time of the shareholder's personal taxation. From a purely economic and financial standpoint, however, it is conceivable that such profits should be treated as though they were profits of a distinct company in State A where the permanent establishment of a company which is a resident of State B is situated, and, to the extent that they are distributed, carry the "avoir fiscal" or "tax credit". But to take the matter further, to avoid all discrimination it is necessary that this advantage should already have been accorded to shareholders who are residents of State B of companies which are residents of State A. From the practical standpoint, the two States concerned should, of course, agree upon the conditions and procedures for allowing the "avoir fiscal" or "tax credit" to shareholders who are themselves residents of either State, of the companies concerned that are residents of State B.

45. Contracting States which are faced with the problems described above may settle them in bilateral negotiations in the light of their peculiar circumstances.

D. Withholding Tax on Dividends, Interest and Royalties Received by a Permanent Establishment

46. When permanent establishments receive dividends, interest, or royalties such income, by virtue of paragraph 4 of Articles 10 and 11 and paragraph 3 of Article 12, respectively, comes under the provisions of Article 7 and consequently — subject to the observations made in paragraph 36 above as regards dividends received on holdings of permanent establishment — falls to be included in the taxable profits of such permanent establishments (cf. paragraph 34 of the Commentary on Article 7).

47. According to the respective Commentaries on the above-mentioned provisions of Articles 10, 11 and 12 (cf. respectively paragraphs 30, 22 and 15), these provisions dispense the State of source of the dividends, interest or royalties received by the permanent establishment from applying any limitation provided for in those Articles, which means — and this is the generally accepted interpretation — that they leave completely unaffected the right of the State of source, where the permanent establishment is situated, to apply its withholding tax at the full rate.

[p. 172] 48. While this approach does not create any problems with regard to the provisions of paragraph 4 of Article 24 in the case of countries where a withholding tax is levied on all such income, whether the latter be paid to residents (permanent establishments, like resident enterprises, being allowed to set such withholding tax off against the tax on profits due by virtue of Article 7) or to non-residents (subject to the limitations provided for in Articles 10, 11 and 12), the position is different when withholding tax is applied exclusively to income paid to non-residents.

49. In this latter case, in fact, it seems difficult to reconcile the levy of withholding tax with the principle set out in paragraph 4 that for the purpose of taxing the income which is derived from their activity, or which is normally connected with it — as is recognised to be the case with dividends, interest and royalties referred to in paragraph 4 of Articles 10 and 11 and in paragraph 3 of Article 12 — permanent establishments must be treated as resident enterprises and hence in respect of such income be subjected to tax on profits solely.

50. In any case, it is for Contracting States which have this difficulty to settle it in bilateral negotiations in the light of their peculiar circumstances.

E. Credit for Foreign Tax

51. In a related context, when a permanent establishment receives foreign income which is included in its taxable profits, it is right by virtue of the same principle to grant to the permanent

establishment credit for foreign tax borne by such income when such credit is granted to resident enterprises under domestic laws.

52. If in a Contracting State (A) in which is situated a permanent establishment of an enterprise of the other Contracting State (B) credit for tax levied in a third State (C) can be allowed only by virtue of a convention, then the more general question arises, as to the extension to permanent establishments of the benefit of conventions concluded with third States, which is examined in paragraph 54 below.

53. It should, however, be pointed out that difficulties may arise as to the amount of the credit to be allowed, if permanent establishments in State A benefit from the convention which State B has concluded with State C. Such amount may be either the amount of tax effectively collected by State C or the amount of tax which State C may collect by virtue either of its convention with State A or its convention with State B. Moreover, the question arises whether such credit is not given twice, i.e. once in State A, where the permanent establishment is situated and again in State B, the State of residence. It is for Contracting States to settle such problems, if necessary, in their bilateral negotiations.

F. Extension to Permanent Establishments of the Benefit of Double Taxation Conventions Concluded with Third States

54. While an enterprise of a State (A) can normally claim, in respect of the permanent establishment which it possesses in another State (B), the benefit of the provisions of the convention between those two States A and B, it nevertheless cannot, should such permanent establishment derive income from a third State (C), invoke the provisions of the convention between States B and C for the [p. 173] benefit of such permanent establishment since it, the enterprise, is in fact resident of neither of those two States (cf. Article 1). This is the consequence of the well-known principle of the relative effect of treaties, which means that they have effect only as between the Contracting States.

55. Nor could such an enterprise invoke for this purpose a most-favoured-nation clause, however general its terms, included

in a treaty or agreement concluded between States A and B. In fact, it has always been accepted that such a clause did not apply in the case of double taxation conventions because these are essentially based on the principle of reciprocity. It should, however, be noted that some States have made provision in their double taxation conventions enabling the provisions of the latter to be applied, "in special cases", to permanent establishments of enterprises of a third State.

Paragraph 5

56. This paragraph is designed to end a particular form of discrimination resulting from the fact that in certain countries the deduction of interest, royalties and other disbursements allowed without restriction when the recipient is resident, is restricted or even prohibited when he is a non-resident. The same situation may also be found in the sphere of capital taxation, as regards debts contracted to a non-resident. It is however open to Contracting States to modify this provision in bilateral conventions to avoid its use for tax avoidance purposes.

Paragraph 6

57. This paragraph forbids a Contracting State to give less favourable treatment to an enterprise, the capital of which is owned or controlled, wholly or partly, directly or indirectly, by one or more residents of the other Contracting State. This provision, and the discrimination which it puts an end to, relates to the taxation only of enterprises and not of the persons owning or controlling their capital. Its object therefore is to ensure equal treatment for taxpayers residing in the same State, and not to subject foreign capital, in the hands of the partners or shareholders, to identical treatment to that applied to domestic capital.

Paragraph 7

58. This paragraph states that the scope of the Article is not restricted by the provisions of Article 2. The Article therefore applies to taxes of every kind and description levied by, or on behalf of, the State, its political subdivisions or local authorities.

Observations on the Commentary

59. The interpretation given in paragraphs 40 and 41 above is not endorsed by *Germany*, the tax laws of which require the application of a minimum rate with respect to non-residents. Under German tax laws, the profits of a permanent establishment of an enterprise operated in Germany by a non-resident individual are charged income tax at a minimum rate of 25 per cent. On the other hand, the German tax laws restrict the application of higher rates by strictly limiting the basis for determining the rate applicable to profits derived from German sources — thus excluding any profits derived by those parts of the enterprise which are situated abroad. Moreover, since the minimum rate of 25 percent is close to [p. 174] the lower end of the progressive tax scale which ranges from 22 per cent to 56 per cent, Germany is of the opinion that the application of the minimum rate of 25 per cent does not violate the provisions of paragraph 4.

60. The *United States* observes that its non-resident citizens are not in the same circumstances as other non-residents, since the United States taxes its non-resident citizens on their worldwide income.

Reservations on the Article

61. *Australia, Canada* and *New Zealand* reserve their positions on this Article.

Paragraph 1

62. *France* accepts the provisions of paragraph 1 but wishes to reserve the possibility of granting only to French nationals the exemption, provided for in its domestic laws, of gains from the alienation of immovable property which constitutes, whether in whole or in part, the residence in France of French nationals who are domiciled abroad.

63. The *United Kingdom* reserves its position on the second sentence of paragraph 1.

Paragraph 4

64. *Belgium* reserves the right to apply the provisions of its internal law for the purpose of taxing the profits of Belgian permanent establishments of companies and associations resident in countries with which it undertakes negotiations, whenever such an attitude is warranted by the general treatment accorded in such countries to permanent establishments of companies and associations resident in Belgium (paragraph 4).

65. *Japan* reserves the right not to extend to the permanent establishments of non-residents the benefit of tax incentive measures introduced for national policy objectives.

Paragraph 5

66. France accepts the provisions of paragraph 5 but wishes to reserve the possibility of applying the provisions in its domestic laws relative to the limitation to the deduction of interest paid by a French company to a foreign parent company.

* * *

EXHIBIT 45

[p. 223-3] TREASURY DEPARTMENT'S MODEL INCOME TAX TREATY OF MAY 17, 1977

[¶ 153]

CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF .... FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND CAPITAL

The Government of the United States of America and the Government of ...., desiring to conclude a convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital, have agreed as follows:

* * *

Article 2
TAXES COVERED

[p. 223-3] 1. This Convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State.

2. The existing taxes to which this Convention shall apply are:

(a) In the United States: the Federal income taxes imposed by the Internal Revenue Code and the excise taxes imposed on insurance premiums paid to foreign insurers and with respect to private foundations, but excluding the accumulated earnings tax and the personal holding company tax.

(b) In ....: ....

3. The Convention shall apply also to any identical or substantially similar taxes which are imposed by a Contracting State after the date of signature of this Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any changes which have

been made in their respective taxation laws and shall notify each other of any official published material concerning the application of this Convention, including explanations, regulations, rulings, or judicial decisions.

[p. 224] 4. For the purpose of Article 24 (Non-Discrimination), this Convention shall also apply to taxes of every kind and description imposed by a Contracting State or a political subdivision or local authority thereof. For the purpose of Article 26 (Exchange of Information and Administrative Assistance), this Convention shall also apply to taxes of every kind imposed by a Contracting State.

* * *

[p. 225] TREASURY'S MODEL CONVENTION

Article 5

PERMANENT ESTABLISHMENT

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" shall include especially:

(a) a branch;

(b) an office;

(c) a factory;

(d) a workshop; and

(e) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources.

3. A building site or construction or installation project, or an installation or drilling rig or ship used for the exploration or development of natural resources, constitutes a permanent establishment only if it lasts more than 24 months.

4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:

(a) the use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the enterprise;

(b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

(c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

(d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;

(e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

(f) the maintenance of a fixed place of business solely for any combination of the activities mentioned in subparagraphs (a) to (e) of this paragraph.

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person—other than an agent of an independent status to whom paragraph 6 applies—is acting on behalf of an enterprise and has and habitually exercises in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on

business in that State through a broker, general [p. 226] commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

* * *

Article 7

BUSINESS PROFITS

1. The business profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situtated therein. If the enterprise carries on business as aforesaid, the business profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the business profits which it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions.

3. In determining the business profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses incurred for the purposes of the enterprise as a whole (or the part thereof which includes the permanent establishment), whether incurred in the State in which the permanent establishment is situated or elsewhere.

4. No business profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

5. For the purposes of the preceding paragraphs, the business profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

6. Where business profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

[p. 227] 7. For the purposes of this Convention, "business profits" means income derived from any trade or business whether carried on by an individual, company or any other person, or group of persons, including the rental of tangible personal (movable) property, and the rental or licensing of cinematograph films or films or tapes used for radio or television broadcasting.

* * *

Article 9

ASSOCIATED ENTERPRISES

1. Where

(a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

(b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of

those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State, and taxes accordingly, profits on which an enterprise of the other Contracting State has been charged to tax in that other State, and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

3. The provisions of paragraph 1 shall not limit any provisions of the law of either Contracting State which permit the distribution, apportionment or allocation of income, deductions, credits, or allowances between persons owned or controlled directly or indirectly by the same interests when necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such persons.

* * *

[p. 233] TREASURY'S MODEL CONVENTION

Article 24

NON-DISCRIMINATION

1. Nationals of a Contracting State shall not be subjected in the other State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected. For purposes of the preceding sentence, nationals who are subject to tax by a Contracting State on worldwide income are not in the same circumstances as nationals who are not so subject. This provision shall, notwithstanding the provisions of Article 1 (Personal Scope), also apply to persons who are not residents of one or both of the Contracting States.

2. The term "nationals" means:

(a) in relation to ....

....

....

(b) in relation to the United States, United States citizens.

3. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

4. Except where the provisions of paragraph 1 of Article 9 (Associated Enterprises), paragraph 5 of Article 11 (Interest), or paragraph 4 of Article 12 (Royalties) apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deducti-

ble under the same condition as if they had been paid to a resident of the first-mentioned State. For purposes of this paragraph, the term "other disbursements" shall include charges for amounts expended by such residents for purposes of such enterprise, including a reasonable allocation of executive and general administrative expenses (except to the extent representing the expenses of a type of activity which is not for the benefit of such enterprise, but constitute "stewardship" or "over-seeing" functions undertaken for such resident's own benefit as an investor in the enterprise), research and development, and other expenses incurred by such resident for the benefit of a group of related enterprises including such enterprise. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.

5. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

6. The provisions of this Article shall, in accordance with the provisions of paragraph 4 of Article 2 (Taxes Covered), apply to taxes of every kind and description imposed by a Contracting State or a political subdivision or local authority thereof.

EXHIBIT 46C

DEPARTMENT OF THE TREASURY
Washington, D.C. 20220

Apr. 22, 1980

Dear Barber:

In response to your letter of March 31, 1980, I am enclosing replies to the five questions you raised on the relationship between the unitary apportionment issue and our tax treaty negotiations.

Sincerely,

/s/ Donald L. Lubick

Donald C. Lubick

The Honorable
Barber B. Conable, Jr.
House of Representatives
Washington, D.C 20515

Enclosure

Questions on the Relationship Between the Unitary Apportionment Method and U.S. Tax Treaty Negotiations

Question 1:

Can you tell the Committee how treaty negotiations are being affected by the Unitary concept?

Answer:

Many countries with which we have had tax treaty negotiations in recent years have expressed serious concern about the application of unitary apportionment systems to corporate groups based in their countries. Our inability to provide a positive response to this concern weakens, somewhat, our overall bargaining position in negotiations. This is particularly true in cases where we are seeking relief from state or local taxes in the other country. Thus, there is a cost to the United States in our inability to satisfy other countries on this issue.

Question 2:

Does it appear as though another attempt will be made to limit the application of the Unitary method by treaty?

Answer:

We continue to believe that Article 9(4) in the U.K. treaty as originally negotiated represented an appropriate use of the treaty making authority. We do not, however, presently intend to put such a provision in any treaty currently under negotiation. While I would not foreclose the possibility of doing so at some time in the future, we wish to see what action will be taken on H.R. 5076 as well as similar bills in state legislatures.

Question 3:

Although the Unitary method limitation in the US-UK income treaty was defeated, has the UK indicated any interest in reviving the issue?

Answer:

The Senate reservation on the unitary apportionment limitation provision of the U.S.-U.K. treaty (Article 9(4) raised serious concerns in the U.K. as to the advisability of the U.K. ratifying the treaty. This issue held up U.K. Parliamentary approval of the treaty while a number of Conservative M.P.'s satisfied themselves that adequate steps were being taken in the U.S. (in Congress, state legislatures, and the courts) to resolve the issue. After heated Parliamentary debate, the treaty was approved. However, at the time of the exchange of instruments of ratification, the British Government sent a formal diplomatic note stating its continuing concern over the unitary apportionment issue and requesting that the Government of the United States "use its best endeavors to eliminate the international application of the unitary basis of taxation."

Question 4:

The Joint Committee's pamphlet notes that during recent treaty discussions with the French, the Unitary method was discussed. Can you elaborate on these discussions and tell the Committee if any other Governments have raised the Unitary tax issue with the Treasury?

Answer:

The unitary apportionment issue was discussed at length during the negotiation of the recent Protocol to the U.S.-French income tax Convention. The French negotiators accepted the fact that, on the basis of our experience with the U.K. treaty, the Treasury was unable to achieve ratification of a Protocol limiting unitary apportionment. They insisted, however, on an exchange of notes calling attention to French concern and obligating the United States to reopen discussions with France on this subject if an acceptable provision can be devised. A copy of the relevant paragraphs of that note is attached.

A number of other countries have also raised this issue. Denmark, Italy, Germany and Canada have made strong representations during tax treaty negotiations. The Netherlands and

Italy (on behalf of the EEC member countries) have sent formal diplomatic notes on this subject.

Question 5:

In your judgement does the Unitary method work mostly to the detriment of domestic or foreign business?

Answer:

The application of the Unitary method to non-U.S. members of a corporate group raises three fundamental problems: (1) It may distort the measurement of income for state tax purposes; (2) it imposes a difficult administrative burden on the taxpayer, who must provide information in the language and currency of the jurisdiction applying the method with respect to a large number of related companies; and (3) it is an irritant in U.S. relations with a number of other countries. The first of these problems applies equally to both U.S. and foreign based corporate groups. The second and third apply principally to foreign based groups. Thus, while the application of the method raises problems for all multinational groups, foreign based groups are more seriously affected than groups controlled by a U.S. parent.

Excerpts from U.S.-France Exchange of Notes

2. It is the position of the Government of France that the so-called "unitary apportionment" method used by certain states of the United States to allocate income to the United States offices or subsidiaries of French corporations, results in inequitable taxation and imposes excessive administrative burdens on French corporations doing business in those states. Under that method the profit of a French company on its United States business is not determined on the basis of arm's length relations but is derived from a formula taking account of the income of the French company and its worldwide subsidiaries as well as the assets, payroll, and sales of all such companies.

For a French multinational corporation with many subsidiaries in different countries to have to submit its books and records for

all of these corporations to a United States state, in English, imposes a costly burden.

It is understood that the Senate of the United States has not consented to any limitation on the taxing jurisdiction of the states by treaty and that a provision which would have restricted the use of unitary apportionment in the case of United Kingdom corporations was recently rejected by the Senate. The Government of France continues to be concerned about this issue as it affects French multinationals. If an acceptable provision on this subject can be devised, the United States agrees to reopen discussions with France on this subject.

CONGRESS OF THE UNITED STATES
[HOUSE OF REPRESENTATIVES]
[LETTERHEAD]
Washington, D.C. 20515

March 31, 1980

Donald C. Lubick
Assistant Secretary of Tax Policy
Department of the Treasury
15th and Pennsylvania Avenue
Washington, D.C. 20220

Dear Don,

Thank you for your recent testimony on H.R. 5076 concerning States' taxation of foreign source income, which I co-sponsored with Representative Jones.

After reviewing your written statement I ahve several questions that I'd like you to answer relating to the effect this issue may have on our treaty negotiations. I am attaching the questions to this letter.

Sincerely,

BARBER B. CONABLE, JR.
Member of Congress

1. Can you tell the Committee how treaty negotiations are affected by the Unitary concept?

2. Does it appear as though another attempt will be made during the application of the Unitary method by treaty?

3. Although the Unitary method limitation in the US-UK income treaty was defeated, has the UK indicated any interest in reviving the issue?

4. The Joint Committee's pamphlet notes that during recent treaty discussions with the French, the Unitary method was discussed. Can you elaborate on these discussions and tell the Committee if any other Governments have raised the Unitary tax issue with the Treasury?

5. In your judgement does the Unitary method work mostly to the detriment of domestic or foreign business?

EXHIBIT 46D

United States Department of State
Washington, D.C. 20520

July 30, 1985

To Whom It May Concern:

I, Frank M. Machak, state the following:

I am Chief, Information Access and Services Division, Foreign Affairs Information Management Center, and am responsible for the maintenance of the records of the U.S. Department of State.

The attached document hereunto annexed is a true copy of a document retrieved from the files of the Department of State.

I declare, under penalty of perjury, that the foregoing statements are true and correct.

/s/ FRANK M. MACHAK
Frank M. Machak
Chief, Information Access
and Services Division

Attachment:

Statement by Allen Wallis (Under Secretary of State for Economic Affairs) Concerning the Chairman's Working Group Report, taken from the Final Report of the Worldwide Unitary Taxation Working Group, August 1984.

UNDER SECRETARY OF STATE
FOR ECONOMIC AFFAIRS
WASHINGTON

STATEMENT BY ALLEN WALLIS CONCERNING THE CHAIRMAN'S WORKING GROUP REPORT

I support the Working Group's recommendation for a "water's edge" limitation on unitary taxation, which I believe will resolve much of the controversy surrounding this issue.

The unitary method of estimating taxable income has provoked sharp criticism from all of our major trading partners. Indeed, Secretary Shultz has said that in his tenure at the State Department few issues have provoked so broad and intense a reaction from foreign nations. The United States Government has received diplomatic notes from fourteen member countries of the Organization for Economic Cooperation and Development (OECD), either directly or through the European community, as well as communications from the OECD itself, all protesting against the application of the unitary tax method to their companies. The OECD countries account for nearly 90% of foreign direct investment in the United States, over 70% of total United States investment abroad and over 80% of United States trade (OECD figures).

Representations have been made at the highest level. The Prime Ministers of three of our largest trading partners have written to the President to express their concern and have raised the issue in personal meetings with him. The Foreign Ministers of these countries also have raised the issue with Secretary Shultz.

Our trading partners have five principal criticisms, all of which are sound:

1. The unitary tax method imposes an onerous administative burden, particularly for foreign-based multinationals.

The financial records of foreign-based companies are not kept in dollars or in English or in accordance with U.S. accounting standards, but states imposing the worldwide method require that

the worldwide earnings of a multinational be reported in these terms. Fluctuating exchange rates further complicate the picture. Although foreign subsidiaries of U.S.-based firms report to their parents in dollars, they too incur significant burdens in standardizing their reports.

2. The unitary tax method leads inevitably to extra-territorial and double taxation.

The underlying assumption of the unitary method is that there are uniform returns to sales, property and payroll throughout the world, but international investment occurs precisely because such returns differ throughout the world. Where there is greater risk, there would be little incentive to invest without relatively high rates of return as a compensation. The worldwide unitary method allows a state to reach beyond its borders and tax higher profits earned elsewhere.

Tax rates imposed by central governments vary, and often are higher in foreign countries than in the United States. Although we have concluded tax treaties with our major trading partners to avoid double taxation at the Federal level, no such arrangements exist for state taxes. Thus, for our own companies, income that is already taxed abroad is fully exposed to state taxation through application of the unitary tax method. Some foreign-based companies find themselves unable, in countries levying taxes on a territorial basis, to obtain tax credits for taxes paid to states using the unitary method on income earned in those countries.

3. The unitary tax method is contrary to international practice.

Formula apportionment (as unitary taxation is also called) was rejected as an international standard by the League of Nations many years ago. Instead, the United States actively has supported adoption of separate accounting, with arms-length adjustment, as the international standard. Years of effort by all the OECD member nations resulted in agreement on the OECD model Tax Convention which calls for separate or "arm's length" accounting, a method that more nearly corresponds with the way business is actually conducted.

4. Use of the unitary tax method by states of the United States encourages the developing countries to adopt the same method.

The developing countries share many of the same concerns about transfer pricing that certain states use to justify their use of unitary taxation, and these countries are being urged by some to adopt the unitary tax method. This would have a major impact on U.S. investment in these countries. The formulas and definitions such countries might use would be unlikely to result in fair and reasonable apportionment of taxable income. One result would be a reduction in flows of equity investment to the developing countries.

5. The unitary tax method discourages investment in those states that apply unitary taxation. It also discourages investment in the United States generally since any state may adopt the tax method.

This last point requires special emphasis.

In September 1983, President Reagan stated that the fundamental premise of our international investment policy is that foreign investment flows which respond to private market forces will lead to more efficient international production and thereby benefit both home and host countries. The President also noted that as the premier home and host country for foreign direct investment, the United States has a substantial interest in the conditions under which those flows occur.

Foreign governments have informed us that, "The (unitary tax) method can chill international investment and decrease efficient allocation of resources and employment opportunities. In particular, the unitary method can impede foreign entry into the United States market." In their view a unitary tax constitutes "... a serious obstacle to the further development of our trade and investment relationships." (Note signed by the Ambassadors of fourteen of our major trading partners). There have also been calls for retaliation.

Added to this are the statements from foreign business organizations like the Keidanren, which represents over 800 Japanese corporations: 'Unitary taxation is the single most serious deterrent to new investment by Japanese enterprises in some states of the United States." The French Patronat, which represents a wide range of the biggest French industries with investment in the United States, described the unitary taxation method in a de-

marche to our Ambassador in Paris as "...not suited to the reality nor to the development of foreign investment, particularly between industrialized countries."

State government officials have also criticized the effects of unitary taxation. The unitary basis of taxation "...is contrary to the long established traditional spirit of welcoming foreign investment in the United States....We urge those states which have the law to repeal it." (News release of the American States Offices Association, whose members represent 21 states' offices and port authorities in Japan, 12/15/83). "Within six months of the passage of... not only have major investments been put on hold or cancelled, but... (worldwide unitary taxation) not only have major investments been put on hold or cancelled, but... the state's new tax policy is a major negative factor with more than half of the state's economic development prospects....The state should take action as quickly as possible to eliminate this controversy." (March 1984 report of the Florida Unitary Tax Study Commission).

The benefits of new investment in terms of jobs, economic development and tax revenue are clear, and competition among the states for such investment is intense. Oregon already has repealed its worldwide unitary tax measure, as Illinois did earlier. Florida and Indiana probably will do so soon. All were responding to the concerns of present and potential multinational investors.

I believe that the Working Group's recommendations are in the best interest of the individual states, and of the United States, which has consistently sought to support fair and consistent treatment of international investment. I urge those states which now apply the unitary tax method to carry out the Working Group's recommendations promptly.

Allen Wallis

EXHIBIT 46E

FOR RELEASE UPON DELIVERY
9:00 a.m. (E.D.T.)
June 24, 1980

STATEMENT OF THE HONORABLE
DONALD C. LUBICK
ASSISTANT SECRETARY OF THE TREASURY
FOR TAX POLICY
BEFORE THE SENATE FINANCE SUBCOMMITTEE
ON TAXATION AND DEBT MANAGEMENT
ON S. 983 AND S. 1688

Mr. Chairman and members of this distinguished Committee:

It is a pleasure to appear before this Committee to discuss the Treasury Department's views concerning the issues raised by S. 983 and S. 1688 regarding state taxation of foreign source income. The primary objective of S. 983 transcends the foreign income issue; the bill would establish national standards governing state taxation of interstate commerce. While the issues associated with this broader objective are very important, they are not, strictly speaking, Federal tax policy issues. Accordingly, my comments will be confined to the foreign income issues raised by the two bills. S. 983 and S. 1688 would clarify the extent to which a state, or political subdivision, may take account of certain income from sources outside the United States in imposing its income tax.

Each bill has two distinct parts, one dealing with state unitary apportionment taxation systems as applied to essentially foreign corporations and the other dealing with state taxation of foreign source income. Regarding the foreign source income part, S. 1688 is restricted to dividends received from a foreign corporation whereas S. 983 also applies to interest, rents, royalties, license and technical fees, and gains from a foreign source.

Under the unitary method of apportionment, as applied in several states, the income of a corporation doing business in a state is determined for state income tax purposes by applying a formula which usually includes the income, payroll, property, and

sales of the corporation subject to tax, as well as all related corporations which are considered part of a unitary business. Thus, the income of a corporation doing business in a state is determined by dividing or apportioning the total domestic and foreign income for the controlled corporate group according to the relation between the corporation's in-state activities and the world-wide activities of the entire corporate group. Unitary apportionment may be contrasted with the typical formula apportionment method used by nearly all the states which divides or apportions the income of a single corporation in relation to its business activities in the jurisdictions in which it operates. A unitary business generally exists where there is (1) common ownership; (2) centralized operation, such as purchasing, advertising, and accounting; and (3) a centralized executive force. No distinction is made, in some states, between U.S. and foreign corporations or between corporate groups controlled by U.S. corporations and those controlled by foreign corporations. The unitary apportionment part of S. 983 and S. 1688 is aimed at the practice of including foreign corporations in the unitary apportionment system.

This practice creates three types of problems. First, it may result in a determination of income for state tax purposes which is substantially different than the income which would be attributed to the corporation doing business in the state on an arm's-length or separate accounting basis. To the extent that the relationship between the apportionment factors (usually payroll, property, and sales) and the income to be apportioned differs markedly in foreign countries from the relationship which generally applies within the United States, the measurement of income by this method can result in serious distortions. In practice, the unitary apportionment system appears to generate substantially more tax revenue for the states than does the arm's length or separate accounting method. Second, the practice may impose a substantial administrative burden on a taxpayer, involving annual translation of the books of a large number of foreign corporations into U.S. accounting concepts and U.S. currency. Third, the practice has created, and continues to create, an irritant in the international relations of the United States. A number of foreign governments have complained, both officially and informally, that the

unitary system differs from the arm's-length method which is used by the Federal Government and is generally accepted in international practice.

Although the restrictions on the unitary apportionment method in the two bills differ, the intent is the same: to prohibit application of the unitary method to essentially foreign corporations. Section 303(b) of S. 983 provides that in determining a corporation's taxable income on a combined or consolidated basis, no state may require and no corporation may elect that the combined affiliated group include any corporation deriving substantially all of its income from sources outside the United States. A corporation fulfills the "substantially all" test if at least 80 percent of its gross income if derived from sources outside the United States over the preceding three-year period. Although Section 303(b) would apply to either domestic or foreign corporations, the 80 percent test demonstrates that it is designed to prohibit application of the unitary method to corporations with basically foreign operations. The unitary portion of S. 1688, reflected in paragraphs (a) through (d) of a proposed new section 7518 of the Internal Revenue Code, would prohibit any state or political subdivision, in imposing tax on any corporation, from taking into account in its unitary apportionment formula the income of any foreign corporation which is a member of an affiliated group including the foreign corporation and the corporation subject to tax, unless the income of "the corporation" (presumably the foreign corporation) is subject to Federal income tax.

Although neither bill distinguishes between corporate groups under Unites States control and those under foreign control, such a distinction may be warranted. Of the three types of problems created by the international application of the unitary method of apportionment, only the first — the potential for a distorted measurement of taxable income — applies fully with respect to U.S. based multinational groups. U.S. parent corporations are already required to submit annual financial statements to the IRS with respect to their overseas subsidiaries. Thus, the administrative burdens which the unitary system creates for foreign based corporate groups are not present to the same degree for a U.S. controlled group. Similarly, the application of a unitary system to

U.S. controlled corporate groups represents much less of an international irritant, if in fact that problem is present at all.

The Treasury Department supports the goals of S. 983 and S. 1688 with respect to affiliated groups controlled by foreign persons. We do not oppose the provisions of these bills insofar as U.S. controlled corporate groups are concerned.

There are, however, several technical problems in paragraphs (a) through (d) of the proposed section 7518 which should be addressed. We have pointed these problems out in a written submission to the Chairman of the House Committee on Ways and Means regarding H.R. 5076, which is identical to S. 1688. We would, of course, be pleased to work with the staff of this Committee in any further drafting that is undertaken.

Each of these bills would also restrict state taxation of income received by a corporation from a foreign source. S. 983 would apply to foreign source income generally, but S. 1688 is restricted to dividends. Forty-six states, including the District of Columbia, levy taxes with respect to corporate income; these taxes are either denominated as income taxes or as excise or franchise taxes measured by income. Only a few states have special rules for the taxation of foreign source income, that is, income from sources outside the United States. In most states, the treatment of foreign source income is determined by the general rules applied by the states for taxing the income of a corporation which operates accross state or national boundaries.

Taxable dividends, interest, rents, royalties, and other items of income received by a corporation, whether domestic or foreign source, usually are apportioned by formula if they are considered business income. Formula apportionment is a method for dividing the tax base among the states, in which the share to be assigned to a particular state is determined by reference to one or more ratios in which economic values or activities of the taxpayer within the state are compared with the taxpayer's total activities or values of the same kind everywhere. (The unitary method discussed above is a special case of formula apportionment in that the formula is applied to the entire affiliated corporate group, rather than to a single corporation.) States differ in how they define business

income. Some presumptively consider nearly all income to be business income. Others define business income less broadly by following the definition of business income less broadly by following the definition of business income in the Uniform Division of Income for Tax Purposes Act. It is:

> . . . income arising from transactions and activity in the regular course of the taxpayer's trade or business [including] . . . income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

Under this narrower definition of business income, most items of nonoperating income would be considered nonbusiness income and would be specifically allocated

Allocation is the attribution of an income item to a specific geographic category; the particular income is thus attributed wholly to a given state, or is wholly excluded from taxation by a given state. Taxable dividends for example, that are considered nonbusiness income, whether domestic or foreign, are usually specifically allocated to the state of the taxpayer's commercial domicile. Rental income from real property is usually allocated to the state of the property's situs.

Section 302 of S. 983 provides that foreign source income received by a corporation may be neither apportioned nor allocated to any state. In addition to dividends, this prohibition would apply to interest, rents, royalties, license and technical fees, and gains from foreign sources. Thus, this bill contains a broad prohibition on the state taxation of foreign source income. In contrast, S. 1688 is addressed only to dividends. S. 1688 would limit state taxation of dividends received by corporations from foreign corporations by requiring that a specified amount of such dividends be excluded from the state tax base. States would be able to tax only the non-excluded portion. The excluded amount is specified for two classes of corporations: (1) domestic corporations (treated as foreign under the bill) whose dividend distributions are, pursuant to Code section 861(a)(2)(A), foreign source and (2) all foreign corporations. The domestic corporations treated as foreign under the bill are corporations which either

have an election in effect under section 936, or which have less than 20 percent of their gross income from United States sources.

The excluded portion of the dividend received from these domestic corporations is equal to the deduction allowed by section 243 of the Code or the amount excluded in determining the tax liability of an affiliated group of corporations in accordance with section 1502 of the Code. Section 243 permits a U.S. corporation to deduct 85 percent of dividends received from another U.S. corporation or 100 percent of qualifying dividends received from members of its affiliated group. Similarly, affiliated corporations, in accordance with section 1502, are entitled to a 100 percent dividend deduction. An affiliated group must be connected through at least 80 percent stock ownership. Thus, S. 1688 would exclude from the states' tax base either 85 percent or 100 percent of dividends received from these corporations.

With respect to dividends received from foreign corporations, the portion excluded by S. 1688 is equal to the greater of the section 78 "gross-up" or the proportion of the dividend, including the section 78 gross-up, that the foreign tax rate bears to the current 46 percent U.S. corporate tax rate. For purposes of the Federal foreign tax credit, section 78 of the Code requires that the underlying foreign corporate taxes on the earnings out of which foreign dividend income is paid be included in the gross income of the corporation receiving the dividend. In effect, dividends from a foreign corporation are increased by the amount of foreign taxes deemed paid by the recipient of the dividends and for which a foreign tax credit is claimed. By removing this gross-up from the tax base, the bill would prohibit states from including in their tax base amounts expended by foreign subsidiaries for foreign taxes.

This exclusion, however, will frequently be less than the alternative exclusion in S. 1688, the proportion of the total, grossed-up dividend that the foreign tax rate (both underlying corporate tax and dividend withholding tax) bears to the current 46 percent U.S. tax rate. Thus, if total foreign taxes also are 46 percent, the excluded portion of the dividend equals 100 percent, and the entire dividend would be excluded from the state tax base. If, instead, the foreign taxes were one-half the current U.S. rate, or

23 percent, one-half the dividend would be excluded from the state tax base.

The question of how states should treat foreign source income for tax purposes deserves far more attention and consideration than we have given it to date. Both S. 983 and S. 1688 would restrict state taxation of foreign source income. Is this the correct result? If so, why does S. 1688 apply to dividends, but not to interest, rents, royalties, and other categories of foreign income? Both bills apply to corporations; why are individuals and other taxpayers excluded? Because a multistate corporation pays both Federal and state income taxes on its operating income, limiting state taxation to U.S. source income may tilt the tax incentives toward foreign investment and employment. Is that appropriate?

Even if we conclude that states ought in principle to be able to tax foreign source income, should the Federal government nonetheless place some limits on that jurisdiction? What happens when two or more states, because of conflicting rules of corporate taxation, assert the right to tax the same income? If states are taxing on the basis of domicile, and not just U.S. source, should they have an obligation to credit foreign taxes or otherwise eliminate international double taxation? S.1688 provides for a partial (or in some cases a total) exclusion of foreign source dividends from taxable income for state tax purposes. But in many cases that formula goes well beyond eliminating double taxation and the formula's underlying rationale is unclear. Perhaps the states should, like the Federal government, allow a credit for foreign taxes paid or deemed paid by the U.S. recipient. That approach would, however, require coordination of foreign tax credits among the state and Federal governments, which may be complex and create other problems.

In short, the issues raised by limitations on state taxation of foreign source income are far more complex and their appropriate resolution far less certain than the unitary apportionment issue for foreign corporations. Because it is critical that we resolve the unitary apportionment problem expeditiously, we favor going forward now with the unitary portion of the bills before us, but holding the foreign income issues over for further consideration.

EXHIBIT 46F

Department of the Treasury NEWS
Washington, D.C. 20220 Telephone 566-2041

FOR RELEASE UPON DELIVERY
10:00 a.m. (E.D.T.)
March 31, 1980

STATEMENT OF THE HONORABLE
DONALD C. LUBICK
ASSISTANT SECRETARY OF THE TREASURY
FOR TAX POLICY
BEFORE THE HOUSE
WAYS AND MEANS COMMITTEE
ON H.R. 5076

Mr. Chairman and members of this Committee:

I am pleased to have the opportunity to appear today to present the views of the Treasury Department on H.R. 5076 which would clarify the extent to which a state, or political subdivision, may take account of certain income from sources outside the United States in imposing its income taxes.

H.R. 5076 has two distinct parts, one dealing with state unitary apportionment taxation systems as applied to foreign corporations and the other dealing with state taxation of dividends received by a corporation from a foreign corporation.

Under unitary apportionment systems as applied in several states, the income of a corporation doing business in the state is determined for state income tax purposes by applying a formula taking account of the income, payroll, property, and sales of the corporation subject to tax and all related corporations which are considered part of a unitary business (i.e., whose activities are dependent upon or contribute to the business of the corporation whose income is being taxed). No distinction is made, in some states, between U.S. and foreign corporations or between corporate groups controlled by U.S. corporations and those controlled by foreign corporations. The first part of H.R. 5076 is aimed at

the practice of including foreign corporations in the unitary apportionment system.

This practice creates three types of problems: (1) It can result in a determination of income for state tax purposes which is substantially different than the income which would be attributed to the corporation doing business in the state if an arm's-length or separate accounting method were used. To the extent that the relationship between the three apportionment factors (payroll, property, and sales) and the income to be apportioned differs markedly in foreign countries from the relationship which generally applies within the United States, the measurement of income by this method can result in serious distortions. In practice, the unitary apportionment system appears in comparison to an arm's length or separate accounting method to generate substantially more taxes for the states. (2) The practice can impose a substantial administrative burden, involving annual translation of the books of what may be a substantial number of foreign corporations into U.S. accounting concepts and U.S. currency. (3) The practice has created, and continues to create, an irritant in the international relations of the United States. A number of foreign governments have complained, both officially and informally, that the unitary system differs from the arm's-length method used by the Federal Government and generally accepted in international practice.

The first part of the bill, reflected in paragraphs (a) through (d) of a proposed new section 7518 of the Internal Revenue Code, would prohibit any state or political subdivision, in imposing tax on any corporation, from taking into account in its unitary apportionment formulas the income of any foreign corporation which is a member of an affiliated group including the foreign corporation and the corporation subject to tax, unless the income of 'the corporation' (presumably the foreign corporation) is subject to Federal income tax.

Although the bill makes no distinction between corporate groups under United States control and those under foreign control, such a distinction may be warranted. Of the three types of problems created by the international application of unitary apportionment, only the first--the potential for a distorted mea-

surement of taxable income--applies fully with respect to U.S. based multinational groups. U.S. parent corporations are already required to submit financial statements to the IRS annually with respect to their overseas subsidiaries. Thus, the administrative burdens which the unitary system creates for foreign based corporate groups are not present to the same degree for a group controlled from the United States. Similarly, the application of a unitary system to U.S. controlled corporate groups represents much less of an international irritant, if in fact that problem is present at all.

The Treasury Department supports the goals of paragraph (a) of the bill, with respect to affiliated groups controlled by foreign persons. We do not oppose the provisions of paragraph (a) of the bill insofar as U.S. controlled corporate groups are concerned.

There are, however, several technical problems in paragraphs (a) through (d) of the proposed section 7518 which should be addressed. We have pointed these problems out in a written submission to the Chairman and would, of course, be pleased to work with the staff in any further drafting that is undertaken.

The second part of H.R. 5076, paragraph (e) of proposed Code section 7518, would restrict state taxation of foreign-source dividends received by corporations. Forty-six states, including the District of Columbia, levy taxes with respect to corporate income; these taxes are either denominated as income taxes or as excise or franchise taxes measured by income. Only a few states have special rules for the taxation of foreign source income, that is, income from sources outside the United States. In most cases, the treatment of foreign source dividend income derives from the general rules for taxing a corporation. Dividends received by corporations from foreign sources are generally excluded from the tax base in about one-third of the states and generally included in the tax base in about two-thirds of the states.

Taxable dividends, whether of domestic or foreign source, usually are apportioned by formula if they are considered business income. Formula apportionment is a method for dividing the tax base among the states, in which the share to be assigned to a particular state is determined by reference to one or more ratios in

which economic values or activities within the state are compared with the taxpayer's total activities or values of the same kind everywhere. States differ in how they define business income. Some presumptively consider nearly all income to be business income. Others define business income less broadly by following the definition of business income in the Uniform Division of Income for Tax Purposes Act. It is:

> ...income arising from transactions and activity in the regular course of the taxpayer's trade or business ... (including) income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

Under this narrower definition of business income, most dividends would be considered nonbusiness income and would be specifically allocated.

Allocation means the attribution of an income item to a specific geographic category; the particular income is thus attributed wholly to a given state, or is wholly excluded from taxation by a given state. Taxable dividends that are considered nonbusiness income, whether domestic or foreign, are usually specifically allocated to the state of the taxpayer's commercial domicile.

The bill would limit state taxation of dividends received by corporations from foreign corporations by requiring that a specified amount of such dividends be excluded from the state tax base. States would be able to tax only the non-excluded portion. The excluded amount is specified for two classes of corporations: (1) domestic corporations (treated as foreign under the bill) whose dividend distributions are, pursuant to Code section 861(a)(2)(A), foreign source and (2) all foreign corporations. Domestic corporations described in section 861(a)(2)(A) are corporations which either have an election in effect under section 936, or which have less than 20 percent of their gross income from United States sources.

The excluded portion of the dividend received from domestic corporations described in section 861(a)(2)(A) is equal to the deduction allowed by section 243 of the Code or the amount excluded in determining the tax liability of an affiliated group of

corporations in accordance with section 1502 of the Code. Section 243 permits a U.S. corporation to deduct 85 percent of dividends received from another U.S. corporation or 100 percent of qualifying dividends received from members of its affiliated group. Similarly, affiliated corporations, in accordance with section 1502, are entitled to a 100 percent dividend deduction. An affiliated group must be connected through at least 80 percent stock ownership. Thus, the bill would exclude from state tax bases either 85 percent or 100 percent of dividends received from corporations with less than 20 percent U.S. source income.

With respect to dividends received from foreign corporations, the excluded portion is equal to the greater of the section 78 "gross-up" or the proportion of the dividend, including the section 78 gross-up, that the foreign tax rate bears to the current 46 percent U.S. corporate tax rate. For purposes of the Federal foreign tax credit, section 78 of the Code requires that the underlying foreign corporate taxes on the earnings out of which foreign dividend income is paid be included in the gross income of the corporation receiving the dividend. In effect, dividends from a foreign corporation are increased by the amount of foreign taxes deemed paid by the recipient of the dividends and for which a foreign tax credit is claimed. By removing this gross-up from the tax base, the bill would prohibit states from including in their tax base amounts expended by foreign subsidiaries for foreign taxes. This exclusion, however, will frequently be less than the alternative exclusion in the bill, the proportion of the total, grossed-up dividend that the foreign tax rate (both underlying corporate tax and dividend withholding tax) bears to the current 46 percent U.S. tax rate. Thus, if total foreign taxes also are 46 percent, the excluded portion of the dividend equals 100 percent, and the entire dividend would be excluded from the state tax base. If, instead, the foreign taxes were one-half the current U.S. rate, or 23 percent, one-half the dividend would be excluded from the state tax base.

The Treasury Department has no objection to requiring that the section 78 "gross-up" be excluded from the state tax base. This would merely require a state to allow an exclusion or deduction for foreign taxes. Although many states already allow

this, it seems reasonable to require all states to recognize foreign taxes as a legitimate business deduction.

The treatment of dividends provided by the remaining provisions of the bill might, however, unintentionally favor foreign over United States investment. Many, but not all, states follow the Federal practice of allowing a general deduction for intercorporate dividends from essentially domestic corporations. Consequently, the exclusion for dividends from foreign corporations provided by this bill might be viewed as placing foreign dividends on an equal tax footing with domestic dividends.

But this overlooks the fact that a multistate corporation pays both Federal and state income taxes on its operating income. The dividends received deduction is intended to prevent the taxation of income that already has borne tax at both the Federal and state levels. Neither Federal nor state income tax is paid, however, on the income of a foreign corporation, until that income is repatriated as a dividend to the domestic corporate shareholder. To the extent this bill excludes these dividends from the state tax base, it eliminates the state level of taxation. Accordingly, multinational operations would be taxed more favorably than multistate operations.

The Treasury Department believes that it is undesirable to create a tax preference for foreign investment. While this is Treasury's primary objection to the second portion of the bill, there are other troublesome aspects. It is unclear why individuals and other taxpayers have been excluded. Similarly, since the bill applies only to dividends, it would favor corporate taxpayers receiving dividends over those receiving rent, interest, and royalty payments. Finally, the bill is geared to the current maximum U.S. corporate rate of 46 percent, rather than the maximum rate in effect at any particular time.

For these reasons, the Treasury opposes the provisions of H.R. 5076 relating to state taxation of foreign-source dividends.

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EXHIBIT 46H

United States Department of State
Washington, D.C. 20520

February 7, 1986

To Whom It May Concern:

I, Frank M. Machak, certify that I am the Acting Director, Foreign Affairs Information Management Center (FAIM) of the United States Department of State. In this capacity, I am the custodian of the official records of the Department of State.

I certify that the document hereunto annexed is a true copy of a document retrieved from the files of the Department of State:

Letter from Secretary of State George P. Shultz to Governor Deukmejian, dated January 30, 1986.

FRANK M. MACHAK
Frank M. Machak
Acting Director
Foreign Affairs Information
Management Center

THE SECRETARY OF STATE
WASHINGTON

January 30, 1986

Dear Governor Deukmejian:

As you are aware, federal legislation was recently introduced with the full support of the Administration which would prohibit states from taxing corporations under the worldwide unitary method and from taxing more than an equitable share of foreign source dividends. This action was taken at the express direction of the President. I am writing to explain to you the foreign policy concerns that prompted this legislation and to urge you to act promptly to reconsider your state's use of the worldwide unitary method of taxation.

When a corporation (or related group of corporations) operates across state or national boundaries, competing tax claims of the jurisdictions in which the corporate group operates are resolved by identifying the income attributable to each jurisdiction. Two different methods are in use for making the determination with respect to transnational income: separate accounting and worldwide unitary combination. The longstanding policy of the federal government has been to follow the separate accounting method. The United States has advocated and adopted the position that the "arm's-length" adjustment method of allocating income among commonly controlled corporations doing business in various national jurisdictions is the appropriate method to be employed. This view is embodied in the Internal Revenue Code and is a central feature in our bilateral tax treaties. Separate accounting is also the international standard. It is prescribed in the model income tax treaties published by the Organization for Economic Cooperation and Development ("OECD") and the United Nations ("UN") and by foreign country tax systems generally. In contrast, the worldwide unitary method of taxation is followed only by seven of the U.S. states. Your state's employment of the worldwide unitary method of tax accounting is at odds with the position of the United States and has become a source of conflict with foreign states.

The Honorable
George Deukmejian,
Governor of California,
Sacramento.

In an environment in which separate accounting is the federal policy and the generally accepted international rule, state taxation on a worldwide unitary basis creates a clear risk of double taxation. Because labor costs and property values vary sharply on an international basis, the rates of profitability of affiliates operating within and without the jurisdiction of the unitary state are often different. Double taxation will result if the relative profitability of the investment in the unitary tax state is less than that of the affiliated overseas operations that are taxed abroad on a separate accounting basis. This risk of double taxation may distort investment decisions, thereby reducing the overall flow of investment into the United States.

Our concern over the worldwide unitary method of taxation's inhibiting effect on foreign investment in the United States is shared by many foreign governments. They have advised us of their view that "The [unitary tax] method can chill international investment and decrease efficient allocation of resources and employment opportunities. In particular, the unitary method can impede foreign entry into the United States market." They contend that the unitary method of taxation constitutes " . . . a serious obstacle to the further development of our trade and investment relationships." (Diplomatic note signed by the Ambassadors of Australia, Belgium, Canada, Denmark, France, Federal Republic of Germany, the United Kingdom, Greece, Ireland, Italy, Japan, Luxembourg, the Netherlands, and Switzerland.)

The administration of the worldwide unitary method of taxation also imposes unreasonable and costly compliance burdens on an enterprise which is considered to be part of a worldwide unitary group. The information required by the tax authorities of the jurisdiction practicing a worldwide unitary method of taxation may not be readily available to the enterprise and, in the case of foreign-controlled entities which are not required to keep data under U.S. tax and financial accounting rules on their non-U.S. operations for any other reason, will require costly conversion into a form usable by the jurisdiction's tax authority.

For these reasons I believe state worldwide unitary taxation to be inappropriate. Continued state taxation on a worldwide unitary basis will greatly impair the ability of the federal government to

carry out its tax and investment policy in the international arena and to manage the sensitive issue of international double taxation. The worldwide unitary issue has seriously complicated our economic relations with many of our closest allies. During my tenure as Secretary of State, this has been a difficult and long-lasting issue. The Department of State has received diplomatic notes complaining about state use of the worldwide unitary method of taxation from virtually every developed country in the world. The unitary issue has been partially responsible for stalling some bilateral tax treaty negotiations.

Most seriously, the U.K. Parliament, in July, 1985, unanimously adopted anti-unitary retaliatory legislation permitting the U.K. government to deny, on a unilateral basis and retroactive to April, 1985, a very valuable benefit of the U.S.-U.K. tax treaty for U.S. corporations operating in worldwide unitary states. This legislation, by virtue of a provision which makes possible the retroactive imposition of heavy penalties, was having a chilling effect on the willingness of U.S. companies to repatriate earnings of their U.K. subsidiaries to the United States and on their willingness to claim benefits properly available to them under the treaty. While the U.K. has agreed to defer implementation of this legislation for the time being, this incident makes it clear that state worldwide unitary taxation is adversely affecting the United States' foreign economic relations.

While the Administration has proposed federal legislation prohibiting worldwide unitary taxation and limiting state taxation of foreign dividends, I would welcome swift legislative or administrative action by your state to terminate your state's use of the worldwide unitary method of taxation and to limit appropriately your state's taxation of foreign source dividends.

Sincerely yours,

George P. Shultz

EXHIBIT 53

Department of International Economic and Social Affairs

UNITED NATIONS
MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES

UNITED NATIONS
NEW YORK, 1980

NOTE

Symbols of United Nations documents are composed of capital letters combined with figures. Mention of such a symbol indicates a reference to a United Nations document.

The designations employed and the presentation of the material in this publication do not imply expression of any opinion whatsoever on the part of the Secretariat of the United Nations concerning the legal status of any country or territory or of its authorities, or concerning the delimitation of its frontiers.

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Chapter VII
Final provisions

Article 28	Entry into force
Article 29	Termination

* * *

[p. 19] Chapter I
SCOPE OF THE CONVENTION

* * *

Article 2

Taxes covered

1. This Convention shall apply to taxes on income [and on capital] imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.

2. There shall be regarded as taxes on income [and on capital] all taxes imposed on total income, [on total capital,] or on elements of income [or of capital,] including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.

3. The existing taxes to which the Convention shall apply are in particular:

(a) (in State A):....................................

(b) (in State B):....................................

4. The Convention shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. At the end of each year, the competent authorities of the Contracting States shall notify each other of changes which have been made in their respective taxation laws.

* * *

[p. 20] Chapter II

DEFINITIONS

* * *

[p. 21] *Article 5*

PERMANENT ESTABLISHMENT

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" includes especially:

(*a*) A place of management;

(*b*) A branch;

(*c*) An office;

(*d*) A factory;

(*e*) A workshop;

(*f*) A mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

3. The term "permanent establishment" likewise encompasses:

(*a*) A building site, a construction, assembly or installation project or supervisory activities in connexion therewith, but only where such site, project or activities continue for a period of more than six months;

(*b*) The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only where activities of that nature continue (for the same or a connected project) within the country for a period or periods aggregating more than six months within any 12-month period.

[p. 22] 4. Notwithstanding the preceding provisions of this article, the term "permanent establishment" shall be deemed not to include:

(*a*) The use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise;

(*b*) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display;

(*c*) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

(*d*) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

(*e*) The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character.

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person — other than an agent of an independent status to whom paragraph 7 applies — is acting in a Contracting State on behalf of an enterprise of the other Contracting State, that enterprise shall be deemed to have a permanent establishment in the first-mentioned Contracting State in respect of any activities which that person undertakes for the enterprise, if such a person:

(*a*) Has and habitually exercises in that State an authority to conclude contracts in the name of the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph; or

(*b*) Has no such authority, but habitually maintains in the first-mentioned State a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise.

6. Notwithstanding the preceding provisions of this article, an insurance enterprise of Contracting State shall, except in regard to re-insurance, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory

of that other State or insures risks situated therein through a person other than an agent of an independent status to whom paragraph 7 applies.

7. An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, he will [p. 23] not be considered an agent of an independent status within the meaning of this paragraph.

8. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise) shall not of itself constitute either company a permanent establishment of the other.

[p. 24] Chapter III

TAXATION OF INCOME

* * *

Article 7

BUSINESS PROFITS

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to (*a*) that permanent establishment; (*b*) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or (*c*) other business activities

carried on in that other State of the same or similar kind as those effected through that permanent establishment.

[p. 25] 2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

3. In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the business of the permanent establishment including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere. However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment. Likewise, no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than towards reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission for specific services performed or for management, or, except in the case of a banking enterprise by way of interest on moneys lent to the head office of the enterprise or any of its other offices.

4. In so far as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the

enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this article.

5. For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

6. Where profits include items of income which are dealt with separately in other articles of this Convention, then the provisions of those articles shall not be affected by the provisions of this article.

> (NOTE: the question of whether profits should be attributed [p. 26] to a permanent establishment by reason of the mere purchase by that permanent establishment of goods and merchandise for the enterprise was not resolved. It should therefore be settled in bilateral negotiations.)

* * *

[p. 27] *Article 9*

ASSOCIATED ENTERPRISES

1. Where:

(*a*) An enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

(*b*) The same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State — and taxes accordingly — profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of the Convention and the competent authorities of the Contracting States shall, if necessary, consult each other.

* * *

[p. 39] Chapter VI

SPECIAL PROVISIONS

Article 24

Non-Discrimination

1. Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected. This provision shall, notwithstanding the provisions of article 1, also apply to persons who are not residents of one or both of the Contracting States.

2. The term "nationals" means:

(*a*) All individuals possessing the nationality of a Contracting State;

(*b*) All legal persons, partnerships and associations deriving their status as such from the laws in force in a Contracting State.

3. Stateless persons who are residents of a Contracting State shall not be subjected in either Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of the State concerned in the same circumstances are or may be subjected.

4. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxaton levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

5. Except where the provisions of paragraph 1 of article 9, paragraph 6 of article 11, or paragraph 6 of article 12 apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. [Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such [p. 40] enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.]

6. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

7. The provisions of this article shall, notwithstanding the provisions of article 2, apply to taxes of every kind and description.

* * *

[p. 43] *Part Two*

Commentaries on the Articles of the United Nations Model Double Taxation Convention between Developed and Developing Countries

* * *

[p. 47] *Article 2*

Taxes covered by the Convention

A. General considerations

Article 2 of the United Nations Model Convention reproduces article 2 of the OECD Model Convention.

This article is designed to clarify and render more precise the terminology and nomenclature concerning the taxes to be covered by the convention. In this connexion, it may be observed that the same income or capital may be subject in the same country to various taxes — either taxes which differ in nature or taxes of the same nature levied by different political subdivisions or local authorities. Hence double taxation cannot be wholly avoided unless the methods for the relief of double taxation applied in each Contracting State take into account all the taxes to which such income or capital is subject. Consequently, the terminology and nomenclature relating to the taxes covered by a treaty must be clear, precise and as comprehensive as possible. As noted in the OECD commentary on article 2 of the OECD Model Convention, this is necessary:

> "to ensure identification of the Contracting States' taxes covered by the Convention, to widen as much as possible the field of application of the Convention by including, as far as possible, and in harmony with the domestic laws of the Contracting States, the taxes imposed by their political subdivisions

or local authorities, and to avoid the necessity of concluding a new convention whenever the Contracting States' domestic laws are modified, by means of the periodical exchange of lists and through a procedure for mutual consultation".

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 2

Paragraph 1

This paragraph indicates that the scope of application of the Convention should encompass taxes on income and on capital, irrespective of the authority on behalf of which such taxes are imposed (e.g., the State itself or its political subdivisions or local authorities) and irrespective of the method by which the taxes are levied (e.g., by direct assessment or by deduction at the source, in the form of surtaxes or surcharges or as additional taxes).

Paragraph 2

This paragraph contains a definition of taxes on income and on capital, which include all taxes on total income, on total capital or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on capital appreciation [p. 48] and taxes on the total amounts of wages or salaries paid by enterprises. According to the commentary on article 2, paragraph 2, of the OECD Model Convention, the last-named taxes do not include "social security charges or any other charges paid where there is a direct connexion between the levy and the individual benefits to be received". The OECD commentary further observes:

"Clearly a State possessing taxing powers — and it alone — may levy the taxes imposed by its legislation together with any duties or charges accessory to them: increases, costs, interest, etc. It has not been considered necessary to specify this in the Article, as it is obvious that in the levying of the tax the accessory duties or charges depend on the same rule as the principal duty.

"The Article does not mention 'ordinary taxes' or 'extraordinary taxes'. Normally, it might be considered justifiable to include extraordinary taxes in a Model Convention, but experience has shown that such taxes are generally imposed in very special circumstances. In addition, it would be difficult to define them. These may be extraordinary for various reasons; their imposition, the manner in which they are levied, their rates, their objects, etc. This being so, it seems preferable not to include extraordinary taxes in the Article. But as it is not intended to exclude extraordinary taxes from all conventions, ordinary taxes have not been mentioned either. The Contracting States are thus free to restrict the convention's field of application to ordinary taxes, to extend it to extraordinary taxes, or even to establish special provisions."

Paragraph 3

This paragraph provides the Contracting States with an opportunity to enumerate the taxes to which the convention is to apply. According to the commentary on article 2, paragraph 3, of the OECD Model Convention, the list "is not exhaustive", for "it serves to illustrate the preceding paragraphs of the article". In principle, however, it is expected to be "a complete list of taxes imposed in each State at the time of signature and covered by the convention".

Paragraph 4

This paragraph supplements paragraph 3 by stating that the Convention is to apply also to any identical or substantially similar taxes which are imposed after the date of signature of the convention in addition to, or in place of, the existing taxes. According to the commentary on article 2, paragraph 4, of the OECD Model Convention, "this provision is necessary to prevent the Convention from becoming inoperative in the event of one of the States modifying its [p. 49] taxation laws". The commentary also notes that "each State undertakes to notify the other of any amendments made to its taxation laws by communicating to it at the end of each year, when necessary, a list of new or substituted taxes, imposed during that year". However, the competent authorities will have to work out the methods for applying para-

graph 4. In some cases countries may choose not to notify each other each year but only when substantive changes are made.

C. OBSERVATION ON THE OECD COMMENTARY AND RESERVATIONS ON ARTICLE 2 OF THE OECD MODEL CONVENTION

Observation on the commentary

"In contexts such as limitations on the rate of tax or the granting of credits for foreign tax, *New Zealand* would wish to make it clear that the term 'tax' does not include penalties."

Reservations on the article

"*Australia, Canada* and the *United States* reserve their positions on that part of paragraph 1 which states that the Convention should apply to taxes of political subdivisions or local authorities.

"*Japan* reserves its position on that part of paragraph 1 which states that the Convention shall apply to taxes on capital."

* * *

[p. 58] Article 5

PERMANANT ESTABLISHMENT

A. GENERAL CONSIDERATIONS

Article 5 of the United Nations Model Convention incorporates a number of provisions of article 5 of the OECD Model Convention (either unchanged or substantially amended) and some new provisions (details on the amendments and new provisions are provided below in the commentary on the paragraphs of the article).

The concept of permanent establishment is used in bilateral tax treaties principally for the purpose of determining the right of a Contracting State to tax the profits of an enterprise of the other Contracting State. According to that concept, an enterprise of one Contracting State is taxable in the other only if it maintains a

permanent establishment in the latter State and only to the extent that the profits earned by the enterprise in that State are attributable to the permanant establishment. The concept of permanent establishment is to be found in the early model conventions including the 1928 model Conventions of the League of Nations. The OECD Model Convention reaffirms the concept and supplements it by introducing the new concept of a "fixed base", to be used in the case of professional services or other activities of an independent character.

B. COMMENTARY ON THE PARAGRAPH OF ARTICLE 5

Paragraph 1

This paragraph, which reproduces article 5, paragraph 1, of the OECD Model Convention, provides a definition of the term "permanent establishment" which emphasized its essential nature as a "fixed place of business" with a specific "situs". According to the commentary [p. 59] on article 5, paragraph 1, of the OECD Model Convention, this definition contains the following conditions:

"— the existence of a 'place of business', i.e. a facility such as premises or, in certain instances, machinery or equipment;

"— this place of business must be 'fixed', i.e. it must be established at a distinct place with a certain degree of permanence;

"— the carrying on of the business of the enterprise through this fixed place of business. This means usually that persons who, in one way or another, are dependent on the enterprise (personnel) conduct the business of the enterprise in the State in which the fixed place is situated."

The OECD commentary goes on to observe:

"It could perhaps be argued that in the general definition some mention should also be made of the other characteristic of a permanent establishment to which some importance has sometimes been attached in the past, namely that the establish-

ment must have a productive character — i.e. contribute to the profits of the enterprise. In the present definition this course has not been taken. Within the framework of a well-run business organization it is surely axiomatic to assume that each part contributes to the productivity of the whole. It does not, of course, follow in every case that because in the wider context of the whole organisation a particular establishment has 'a productive character' it is consequently a permanent establishment to which profits can properly be attributed for the purpose of tax in a particular territory.

"The term 'place of business' covers any premises, facilities or installations used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose. A place of business may also exist where no premises are available or required for carrying on the business of the enterprise and it simply has a certain amount of space at its disposal. It is immaterial whether the premises, facilities or installations are owned or rented by or are otherwise at the disposal of the enterprise. A place of business may thus be constituted by a pitch in a market place, or by a certain permanently used area in a Customs depot (e.g. for the storage of dutiable goods). Again the place of business may be situated in the business facilities of another enterprise. This may be the case, for instance where the foreign enterprise has at its constant disposal certain premises or a part thereof owned by the other enterprise.

"According to the definition, the place of business has to be a 'fixed' one. Thus in the normal way there has to be a link between the place of business and a specific geographical point. It is immaterial how long an enterprise of a Contracting State operates in the other Contracting State if it does not do so at a distinct [p. 60] place, but this does not mean that the equipment constituting the place of business has to be actually fixed to the soil on which it stands. It is enough that the equipment remains on a particular site.

"Since the place of business must be fixed, it also follows that a permanent establishment can be deemed to exist only if the place of business has a certain degree of permanency, i.e. if

it is not of a purely temporary nature. If the place of business was not set up merely for a temporary purpose, it can constitute a permanent establishment, even though it existed, in practice, only for a very short period of time because of the special nature of the activity of the enterprise or because, as a consequence of special circumstances (e.g. death of the taxpayer, investment failure), it was prematurely liquidated. Where a place of business which was, at the outset, designed for a short temporary purpose only, is maintained for such a period that it cannot be considered as a temporary one, it becomes a fixed place of business and thus — retrospectively — a permanent establishment.

"For a place of business to constitute a permanent establishment the enterprise using it must carry on its business wholly or partly through it. As stated in . . . above, the activity need not be of a productive character. Furthermore, the activity need not be permanent in the sense that there is no interruption of operation, but operations must be carried out on a regular basis.

"Where tangible property such as facilities, equipment, buildings, or intangible property such as patents, procedures and similar property, are let or leased to third parties through a fixed place of business maintained by an enterprise of a Contracting State in the other State, this activity will, in general, render the place of business a permanent establishment. The same applies if capital is made available through a fixed place of business. If an enterprise of a State lets or leases facilities, equipment, buildings or intangible property to an enterprise of the other State without maintaining for such letting or leasing activity a fixed place of business in the other State, the leased facility, equipment, building or intangible property, as such, will not constitute a permanent establishment of the lessor provided the contract is limited to the mere leasing of the equipment, etc. This remains the case even when, for example, the lessor supplies personnel after installation to operate the equipment provided that their responsibility is limited solely to the operation or maintenance of the equipment under the direction, responsibility and control of the lessee. If the personnel have wider responsibilities, for example participation in the

decisions regarding the work for which the equipment is used, the activity of the lessor may go beyond the mere leasing of equipment and may constitute an entrepreneurial [p. 61] activity. In such a case a permanent establishment could be deemed to exist if the criterion of permanency is met. When such activity is connected with, or is similar in character to, those mentioned in paragraph 3, the time limit of twelve months[1] applies. Other cases have to be determined according to the circumstances.

"The business of an enterprise is carried on mainly by the entrepreneur or persons who are in a paid-employment relationship with the enterprise (personnel). This personnel includes employees and other persons receiving instructions from the enterprise (e.g. dependent agents). The powers of such personnel in its relationship with third parties are irrelevant. It makes no difference whether or not the dependent agent is authorised to conclude contracts if he works at the fixed place of business. But a permanent establishment may nevertheless exist if the business of the enterprise is carried on mainly through automatic equipment, the activities of the personnel being restricted to setting up, operating, controlling and maintaining such equipment. Whether or not gaming and vending machines and the like set up by an enterprise of a State in the other State constitute a permanent establishment thus depends on whether or not the enterprise carries on a business activity besides the initial setting up of the machines. A permanent establishment does not exist if the enterprise merely sets up the machines and then leases the machines to other enterprises. A permanent establishment may exist, however, if the enterprise which sets up the machines also operates and maintains them for its own account. This also applies if the machines are operated and maintained by an agent dependent on the enterprise.

"A permanent establishment begins to exist as soon as the enterprise commences to carry on its business through a fixed place of business. This is the case once the enterprise prepares,

[1]Six months in the United Nations Model Convention.

at the place of business, the activity for which the place of business is to serve permanently. The period of time during which the fixed place of business itself is being set up by the enterprise should not be counted, provided that this activity differs substantially from the activity for which the place of business is to serve permanently. The permanent establishment ceases to exist with the disposal of the fixed place of business or with the cessation of any activity through it, that is when all acts and measures connected with the former activities of the permanent establishment are terminated (winding up current business transactions, maintenance and repair of facilities). A temporary [p. 62] interruption of operations, however, cannot be regarded as closure. If the fixed place of business is leased to another enterprise, it will normally only serve the activities of that enterprise instead of the lessor's; in general, the lessor's permanent establishment ceases to exist, except where he continues carrying on a business activity of his own through the fixed place of business."

Paragraph 2

Paragraph 2, which reproduces article 5, paragraph 2, of the OECD Model Convention, singles out a number of examples of what can be regarded, *prima facie,* as constituting a permanent establishment. During the discussion, a member from a developing country emphasized the need to broaden as much as possible the scope of the term "permanent establishment" and suggested that a warehouse should be included among the specific examples. However, it was agreed not to expand the list of examples in view of the fact that the deletion of the word "delivery" in subparagraphs (*a*) and (*b*) of paragraph 4 meant that a "warehouse" used for that purpose would constitute a permanent establishment. It was also noted that a "commercial warehouse", where for example space was being rented to other concerns, was covered as a permanent establishment. According to the commentary on article 5, paragraph 2, of the OECD Model Convention, it is assumed that the Contracting States interpret the terms listed "in such a way that such places of business constitute permanent establishments only if they meet the requirements of paragraph 1". With regard to the term "place of management",

the OECD commentary points out that it has been mentioned separately because it is not necessarily an "office" and that "where the laws of the two Contracting States do not contain the concept of a 'place of management' as distinct from an office, there will be no need to refer to the former term in their bilateral convention".

In connexion with subparagraph (*f*), which provides that the term "permanent establishment" includes mines, oil or gas wells, quarries or any other place of extraction of natural resources, the OECD commentary states that "the term 'any other place of extraction of natural resources' should be interpreted broadly" and that it includes, for example, all places of extraction of hydrocarbons whether on or off-shore. The OECD commentary further observes:

> "Subparagraph (*f*) refers to the extraction of natural resources, but does not mention the exploration of such resources, whether on or off-shore. Therefore, whenever income from such activities is considered to be business profits, the question whether these activities are carried on through a permanent establishment is governed by paragraph 1. Since, however, it has not been possible to arrive at a common view on the basic questions of the attribution of taxation rights and of the qualification [p. 63] of the income from exploration activities, the Contracting States may agree upon the insertion of specific provisions. They may agree, for instance, that an enterprise of a Contracting State, as regards its activities of exploration of natural resources in a place or area in the other Contracting State:
>
> "(*a*) shall be deemed not to have a permanent establishment in that other State; or
>
> "(*b*) shall be deemed to carry on such activities through a permanent establishment in that other State; or
>
> "(*c*) shall be deemed to carry on such activities through a permanent establishment in that other State if such activities last longer than a specified period to time.

> The Contracting States may moreover agree to submit the income from such activities to any other rule."

Paragraph 3

This paragraph covers a broader range of activities than article 5, paragraph 3 of the OECD Model Convention. In subparagraph 3 (*a*), in addition to the term "installation project" used in the OECD Model Convention, there is included the term "assembly project" as well as "supervisory activities" in connection with "a building site, a construction, installation or assembly project". In the guidelines the term "assembly project" had been substituted for "installation project" but the group felt on reflection that it would best clarify the status of an installation project in this context if it was specifically mentioned in the paragraph. Another difference from the OECD Model Convention in this paragraph is that while the OECD Model Convention, in article 5, states that a "building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months", article 5, paragraph 3, of the United Nations Model Convention reduces the duration of the relevant site or project to six months. In special cases the six-month period in paragraph 3, subparagraphs (*a*) and (*b*), of the latter article could be reduced in bilateral negotiations to a period of not less than three months.

It may be noted that there was substantial support within the group, especially among members from developing countries, for a more elaborate version of subparagraph 3 (*a*), which would have provided that the term "permanent establishment" should likewise encompass a situation:

> "Where such project or activity, being incidental to the sale of machinery or equipment, continues for a period not exceeding six months and the charges payable for the project or activities exceed 10 per cent of the sale price of the machinery or equipment".

[p. 64] Other members, however, felt that such a provision would not constitute an adequate solution, particularly if the machinery was delivered by an enterprise other than the one doing the construction work.

Concerning the time-limit established in paragraph 3, subparagraphs *(a)* and *(b)*, of article 5 of the United Nations Model Convention, some members of the Group from developing countries said that they would have preferred to remove the time-limit altogether for two main reasons: first, because construction, assembly and similar activities could as a result of modern technology be of very short duration and still result in a considerable profit for the enterprise carrying on those activities; and secondly, because the period during which the foreign personnel involved in the activities remained in the source country was irrelevant to the definition of the right of developing countries to tax the corresponding income. Other members from developing countries felt that any time-limit should have been removed because such a limitation was apt to be used by enterprises of capital-exporting countries to evade taxation in the source country. The view was expressed that there was no reason why a construction project should not be treated in the same manner as artistes, athletes and public entertainers covered by article 17 of the OECD Model Convention, who are taxed at the place where their activities are performed irrespective of the duration of those activities. Members from developed countries observed that the Group's task was to work out guidelines for treaty provisions that would promote international trade and development, and that the idea behind the time-limit was that business enterprises of one Contracting State should be encouraged to initiate preparatory or ancillary operations in the other Contracting State without becoming immediately subject to the tax of the latter State, so as to facilitate a more permanent and larger commitment at a later stage.

Article 5, paragraph 3, of the United Nations Model Convention contains a new subparagraph *(b)* dealing with the furnishing of services, including consultancy services which are not covered specifically in the OECD Model Convention in connexion with the concept of permanent establishment. The Group felt that management and consultancy services should be covered because the provision of such services in developing countries by corporations of industrialized countries often involved very large sums of money. The Group was of the opinion that profits from such services should be taxed by developing countries in certain circumstances. However, some members from developing countries

proposed the inclusion in that paragraph of another criterion based on the amount of remuneration for the furnishing of services. Such criterion would constitute the subject of an additional sub-paragraph, namely subparagraph 3 *(c)*, which would be worded as follows:

> [p. 65] "*(c)* The furnishing of services including consultancy services by an enterprise, but only where the remuneration for activities of that nature (for the same or a connected project) derived from a resident of a Contracting State or a permanent establishment or a fixed base situated therein exceeds in the fiscal year an amount of . . . (an amount to be established through bilateral negotiations)".

Most members agreed that monetary limitations, if set by analogy with those applied to services of individuals in a number of tax treaties, would be meaningless in the area of the corporate services here discussed, while other members were opposed to any monetary limitations. On the other hand, some members felt that the physical presence of representatives of a foreign corporation in the source country for a minimum period, such as six months, would be a reasonable limitation which would, as a practical matter, cover most of the important situations and would preclude administrative difficulties in the case of merely sporadic activities. Some members preferred this paragraph without any limit on the amount of remuneration.

One member from a developed country expressed the view that the above provision might in certain cases have undesirable effects on international trade and on the transfer of technology.

Some members from developed countries thought that the time-limit approach would be an acceptable solution if the words "for the same or a connected project" were inserted after the word "continue", since they thought it desirable to add together unrelated projects in view of the uncertainty which that step involved and the undesirable distinction it created between an enterprise with, for example, one project of three months' duration and another with two projects, each of three months' duration, one following the other. In that respect, other members found that the injection of a "project" limitation would be either too easy to

manipulate or too narrow in that it might preclude taxation in the case of a continuous number of separate projects, each of four or five months' duration.

Some members from developing countries expressed the view that in bilateral negotiations a clause could be inserted in paragraph 3 which would stipulate that fishing ships pertaining to an enterprise of the Contracting State that operated in the territorial waters of the other Contracting State could be considered as permanent establishments in the latter State. In that sense they pointed out as an example that the establishment of a temporary limit on the amount of fish caught etc. would constitute an adequate means of solving the problem.

There was general agreement that only profits from service attributable to a permanent establishment in the source country should be taxable by it. In the context of this paragraph, the following [p. 66] passages of the commentary on article 5, paragraph 3, of the OECD Model Convention are relevant:

> "This paragraph provides expressly that a building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months. Any of those items which does not meet this condition does not of itself constitute a permanent establishment, even if there is within it an installation, for instance an office or a workshop within the meaning of paragraph 2, associated with the construction activity.
>
> "The term 'building site or construction or installation project' includes not only the construction of buildings but also the construction of roads, bridges or canals, the laying of pipe-lines and excavating and dredging. Planning and supervision of the erection of a building are covered by this term, if carried out by the building contractor. However, planning and supervision is not included if carried out by another enterprise whose activities in connection with the construction concerned are restricted to planning and supervising the work. If that other enterprise has an office which it uses only for planning or supervision activities relating to a site or project which does not constitute a permanent establishment, such office does not

> constitute a fixed place of business within the meaning of paragraph 1, because its existence has not a certain degree of permanence.
>
> "The twelve month test applies to each individual site or project. In determining how long the site or project has existed, no account should be taken of the time previously spent by the contractor concerned on other sites or projects which are totally unconnected with it. A building site should be regarded as a single unit, even if it is based on several contracts, provided that it forms a coherent whole commercially and geographically. Subject to this proviso, a building site forms a single unit even if the orders have been placed by several persons (e.g. for a row of houses).
>
> "A site exists from the date on which the contractor begins his work, including any preparatory work, in the country where the construction is to be established, e.g. if he installs a planning office for the construction. In general, it continues to exist until the work is completed or permanently abandoned. A site should not be regarded as ceasing to exist when work is temporarily discontinued. Seasonal or other temporary interruptions should be included in determining the life of a site. Seasonal interruptions include interruptions due to bad weather. Temporary interruption could be caused, for example, by shortage of material or labour difficulties. Thus, for example, if a contractor started work on a road on 1st May, stopped on 1st November because of [p. 67] bad weather conditions or a lack of materials but resumed work on 1st February the following year, completing the road on 1st June, his construction project should be regarded as a permanent establishment because thirteen months elapsed between the date he first commenced work (1st May) and the date he finally finished (1st June of the following year). If an enterprise (general contractor) which has undertaken the performance of a comprehensive project sub-contracts parts of such a project to other enterprises (sub-contractors), the period spent by a sub-contractor working on the building site must be considered as being time spent by the general contractor on the building project.

The sub-contractor himself has a permanent establishment at the site if his activities there last more than twelve months.

"The very nature of a construction or installation project may be such that the contractor's activity has to be relocated continuously or at least from time to time, as the project progresses. This would be the case for instance where roads or canals were being constructed, waterways dredged, or pipelines laid. In such a case, the fact that the work force is not present for twelve months in one particular place is immaterial. The activities performed at each particular spot are part of a single project, and that project must be regarded as a permanent establishment if, as a whole, it lasts more than twelve months."

Paragraph 4

This paragraph reproduces article 5, paragraph 4 of the OECD Model Convention with three substantive amendments, namely the deletion of the term "delivery" in subparagraphs (*a*) and (*b*) and the deletion of subparagraph (*f*). The deletion of the word "delivery" means that a "warehouse" used for that purpose will constitute a permanent establishment. Furthermore, a "commercial warehouse", where space is rented to other concerns, is also a permanent establishment under paragraph 2.

The deletion of the term "delivery" was agreed on after members from developing countries pointed out that the presence of a stock of goods for prompt delivery facilitated the sales of the product and thereby the earning of profit in the host country by the enterprise having the facility. There was a continuous connexion and hence the existence of such a supply of goods, they argued, should constitute a permanent establishment, leaving as a separate matter the determination of the proper amount of income attributable to the permanent establishment. The Group felt that it would be preferable to leave open for bilateral negotiations the question of whether cases involving deliveries made from stocks of goods should be included in or excluded from the definition of permanent establishment. Some members [p. 68] from developed countries pointed out that since in the normal case only a small amount of income would be allocated if the only

activity were that described in the proposed clause, it would not serve any purpose to make the change.

Concerning paragraph 4, subparagraph (*f*), of the OECD Model Convention, although there was a general consensus not to include it in the United Nations Model Convention, some members of the Group indicated that the desirability of including it in a treaty could be left to bilateral negotiation. Subparagraph (*f*) of the OECD Model provides for: "the maintenance of a fixed place of business solely for any combination of activities mentioned in sub-paragraphs (*a*) to (*e*), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character".

Concerning the business activities listed in paragraph 4, the commentary on article 5, paragraph 4, of the OECD Model Convention states that they are "treated as exceptions to the general definition laid down in paragraph 1" and that they "are not permanent establishments, even if the activity is carried on through a fixed place of business". The OECD commentary stresses that "the common feature of these activities is that they are in general preparatory or auxiliary activities" and that "the provisions of paragraph 4 are designed to prevent an enterprise of one State from being taxed in the other State, if it carries on in that other State activities of a purely preparatory or auxiliary character". The following passages of the OECD commentary are likewise relevant to article 5, paragraph 4, of the United Nations Model Convention.

"Subparagraph (*a*) relates only to the case in which an enterprise acquires the use of facilities for storing [or] displaying ..... its own goods or merchandise. Subparagraph (*b*) relates to the stock of merchandise itself and provides that the stock, as such, shall not be treated as a permanent establishment if it is maintained for the purpose of storage [or] display. Subparagraph (*c*) covers the case in which a stock of goods or merchandise belonging to one enterprise is processed by a second enterprise, on behalf of, or for the account of, the first-mentioned enterprise. The reference to the collection of information in subparagraph (*d*) is intended to include the case of the newspaper bureau which has no purpose other than to act

as one of many 'tentacles' of the parent body; to exempt such a bureau is to do no more than to extend the concept of 'mere purchase'.

"Subparagraph (*e*) provides that a fixed place of business through which the enterprise exercises solely an activity which has for the enterprise a preparatory or auxiliary character, is deemed not to be a permanent establishment. The wording of this subparagraph makes it unnecessary to produce an exhaustive list [p. 69] of exceptions. Furthermore, this sub-paragraph provides a generalized exception to the general definition in paragraph 1 and, when read with that paragraph, provides a more selective test, by which to determine what constitutes a permanent establishment. To a considerable degree it limits that definition and excludes from its rather wide scope a number of forms of business organizations which, although they are carried on through a fixed place of business, should not be treated as permanent establishments. It is recognized that such a place of business may well contribute to the productivity of the enterprise, but the services it performs are so remote from the actual realization of profits that it is difficult to allocate any profit to the fixed place of business solely for the purpose of advertising or for the supply of information or for scientific research or for the servicing of a patent or a know-how contract, if such activities have a preparatory or auxiliary character.

"It is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not. The decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole. Each individual case will have to be examined on its own merits. In any case, a fixed place of business whose general purpose is one which is identical to the general purpose of the whole enterprise, does not exercise a preparatory or auxiliary activity. Where, for example, the servicing of patents and know-how is the purpose of an enterprise, a fixed place of business of such enterprise exercising such an activity cannot get the benefits of subparagraph (*e*). A fixed place of business which has the

function of managing an enterprise or even only a part of an enterprise or of a group of the concern cannot be regarded as doing a preparatory or auxiliary activity, for such a managerial activity exceeds this level. If enterprises with international ramifications establish a so-called 'management office' in States in which they maintain subsidiaries, permanent establishments, agents or licensees, such office having supervisory and co-ordinating functions for all departments of the enterprise located within the region concerned, a permanent establishment will normally be deemed to exist, because the management office may be regarded as an office within the meaning of paragraph 2. Where a big international concern has delegated all management functions to its regional management offices so that the functions of the head office of the concern are restricted to general supervision (so-called polycentric enterprises), the regional management offices even have to be regarded as a 'place of management' within the meaning of subparagraph (*a*) of paragraph 2. The function of managing an enterprise, [p. 70] even if it only covers a certain area of the operations of the concern, constitutes an essential part of the business operations of the enterprise and therefore can in no way be regarded as an activity which has a preparatory or auxiliary character within the meaning of subparagraph (*e*) of paragraph 4.

"A permanent establishment could also be constituted if an enterprise maintains a fixed place of business in order to supply spare parts to customers for the machinery supplied to such customers, and to maintain and repair such machinery. Since these after-sale organisations perform an essential and significant part of the services of an enterprise vis-à-vis its customers, their activities are not merely auxiliary ones. Subparagraph (*e*) applies only if the activity of the fixed place of business is limited to a preparatory or auxiliary one. This would not be the case where, for example, the fixed place of business does not only give information but also furnishes plans etc. specially developed for the purposes of the individual customer. Nor would it be the case if a research establishment were to concern itself with manufacture.

"Moreover, subparagraph (*e*) makes it clear that the activities of the fixed place of business must be carried on for the enterprise. A fixed place of business which renders services not only to its enterprise but also directly to the other enterprises, for example to other companies of a group to which the company owning the fixed place belongs, would not fall within the scope of subparagraph (*e*).

"...

"The fixed places of business mentioned in paragraph 4 cannot be deemed to constitute permanent establishments so long as their activities are restricted to the functions which are the prerequisite for assuming that the fixed place of business is not a permanent establishment. This will be the case even if the contracts necessary for establishing and carrying on the business are concluded by those in charge of the places of business themselves. The employees of places of business within the meaning of paragraph 4 who are authorised to conclude such contracts should not be regarded as agents within the meaning of paragraph 5. A case in point would be a research institution the manager of which is authorised to conclude the contracts necessary for maintaining the institution and who exercises this authority within the framework of the functions of the institution. A permanent establishment, however, exists if the fixed place of business exercising any of the functions listed in paragraph 4 were to exercise them not only on behalf of the enterprise to which it belongs but also on behalf of other enterprises. If, for instance, an advertising agency maintained by an enterprise were also to [p. 71] engage in advertising for other enterprises, it would be regarded as a permanent establishment of the enterprise by which it is maintained.

"If a fixed place of business under paragraph 4 is deemed not to be a permanent establishment, this exception applies likewise to the disposal of movable property forming part of the business property of the place of business at the termination of the enterprise's activity in such installation. Since, for example, the display of merchandise is excepted under subparagraphs (*a*) and (*b*), the sale of the merchandise at the termination of a trade fair or convention is covered by this exception. The

exception does not, of course, apply to sales of merchandise not actually displayed at the trade fair or convention.

"A fixed place of business used both for activities which rank as exceptions (paragraph 4) and for other activities would be regarded as a single permanent establishment and taxable as regards both types of activities. This would be the case, for instance, where a store maintained for the delivery of goods also engaged in sales."

Paragraph 5

Since neither paragraph 4 nor paragraph 5 deals with the treatment of a combination of the activities specified in subparagraph 4 (*a*) to subparagraph 4 (*e*), whatever interpretation is given to the omission in paragraph 4 should also apply to paragraph 5. With the addition of subparagraph 5 (*b*), this paragraph departs substantially from and is considerably broader in scope than article 5, paragraph 5, of the OECD Model Convention, which the Group considered to be too narrow in scope because it restricted the type of agent who would be deemed to create a permanent establishment of a non-resident enterprise, exposing it to taxation in the source country.

Some members from developing countries pointed out that a narrow formula might encourage tax evasion by permitting an agent who was in fact dependent to represent himself as acting on his own behalf. It was the understanding of the Group that the phrase "authority to conclude contracts on behalf of" in subparagraph 5 (*a*) of article 5 meant that the agent had legal authority to bind the enterprise for business purposes and not only for administrative purposes (e.g., conclusion of lease or electricity and manpower contracts).

Paragraph 6

This paragraph does not correspond to any provision of the OECD Model Convention. It was included because it was the common feeling of the Group that the OECD definition of permanent [p. 72] establishment was not adequate to deal with certain aspects of the insurance business. Members from develop-

ing countries pointed out that if an insurance agent was independent, the profits would not be taxable in accordance with the provisions suggested in article 5, paragraph 7, of the United Nations Model Convention (based on article 5, paragraph 6, of the OECD Model Convention); and if the agent was dependent, no tax could be imposed because insurance agents normally had no authority to conclude contracts as would be required under the provisions suggested in subparagraph 5(*a*) (based on article 5, paragraph 5, of the OECD Model Convention). Those members expressed the view that taxation of insurance profits in the country where the premiums were being paid was desirable and should take place independently of the status of the agent. They therefore suggested that the United Nations Model Convention should include a special provision relating to insurance business. However, such taxation is based on the assumption that the person (employee or representative) through whom premiums are collected and risk insured, is present in the country where the risk is located.

Once agreement had been reached on the principle of including a special provision on insurance, the discussion in the Group focused mainly on cases involving representation through "an independent agent". Members from developing countries felt it would be desirable to provide that a permanent establishment existed in such cases because of the nature of the insurance business, the fact that the risks were situated within the country claiming tax jurisdiction, and the facility with which persons could, on a part-time basis, represent insurance companies on the basis of an "independent status", making it difficult to distinguish between dependent and independent insurance agents. Members from developed countries, on the other hand, stressed that in cases involving independent agents, insurance business should not be treated differently from such activities as the sale of tangible commodities. Those members also drew attention to the difficulties involved in ascertaining the total amount of business done when the insurance was handled by a number of independent agents within the same country. In view of the difference in approach, the Group agreed that the case of representation through independent agents should be left to bilateral negotiations, which could take account of the methods used to sell

insurance and other features of the insurance business in the countries concerned.

Paragraph 7

The first sentence of this paragraph reproduces article 5, paragraph 6, of the OECD Model Convention in its entirety, with a few minor drafting changes. the commentary on the OECD text reads as follows:

"Where an enterprise of a Contracting State carries on business [p. 73] dealings through a broker, general commission agent or any other agent of an independent status, it cannot be taxed in the other Contracting State in respect of those dealings if the agent is acting in the ordinary course of his business . . . Although it stands to reason that such an agent, representing a separate enterprise, cannot constitute a permanent establishment of the foreign enterprise, paragraph 6 has been inserted in the article for the sake of clarity and emphasis.

"A person will come within the scope of paragraph 6 — i.e. he will not constitute a permanent establishment of the enterprise on whose behalf he acts — only if

"(*a*) he is independent of the enterprise both legally and economically,

"(*b*) he acts in the ordinary course of his business when acting on behalf of the enterprise.

"Whether a person is independent of the enterprise represented depends on the extent of the obligations which this person has vis-à-vis the enterprise. Where the person's commercial activities for the enterprise are subject to detailed instructions or to comprehensive control by it, such person cannot be regarded as independent of the enterprise. Another important criterion will be whether the entrepreneurial risk has to be borne by the person or by the enterprise the person represents. A subsidiary is not to be considered dependent on its parent company solely because of the parent's ownership of the share capital. Persons cannot be said to act in the ordinary course of their own business if, in place of the enterprise, such

persons perform activities which, economically, belong to the sphere of the enterprise rather than to that of their own business operations. Where, for example, a commission agent not only sells the goods or merchandise of the enterprise in his own name but also habitually acts, in relation to that enterprise, as a permanent agent having an authority to conclude contracts, he would be deemed in respect of this particular activity to be a permanent establishment, since he is thus acting outside the ordinary course of his own trade or business (namely that of a commission agent), unless his activities are limited to those mentioned at the end of paragraph 5.

". . . . ."

The second sentence of article 5, paragraph 7, of the United Nations Model Convention constitutes a new provision, whose inclusion stemmed from a proposal by members from developing countries to broaden the scope of the definition of a permanent establishment by treating as a dependent agent an agent who habitually secures orders exclusively or almost exclusively for an enterprise of the other Contracting State or a group of centrally controlled affiliated enterprises. In that situation, the agent shall constitute a permanent [p. 74] establishment for the particular members of the group for whom he is acting at a given time. In support of this proposal it was argued that when an agent, although acting in an independent capacity, acted for only one enterprise and devoted his time and activity wholly or almost wholly to that enterprise, he lost his independent status.

It was stated that the confinement of the activities of an agent wholly or almost wholly to those undertaken on behalf of one enterprise must be pursuant to an agreement with that enterprise. Some members from developing countries felt that the existence of such an agreement should not be a requirement for the application of the United Nations amendment replacing article 5, paragraph 5, of the OECD Model Convention, for in practice it would annul it.

Paragraph 8

This paragraph reproduces article 5, paragraph 7, of the OECD Model Convention. The commentary on the OECD text reads as follows:

"It is generally accepted that the existence of a subsidiary company does not, of itself, constitute that subsidiary company a permanent establishment of its parent company. This follows from the principle that, for the purpose of taxation, such a subsidiary company constitutes an independent legal entity. Even the fact that the trade or business carried on by the subsidiary company is managed by the parent company does not constitute the subsidiary company a permanent establishment of the parent company.

"However, a subsidiary company will constitute a permanent establishment for its parent company under the same conditions stipulated in paragraph 5 as are valid for any other unrelated company, i.e. if it cannot be regarded as an independent agent in the meaning of paragraph 6, and if it has and habitually exercises an authority to conclude contracts in the name of the parent company. And the effects would be the same as for any other unrelated company to which paragraph 5 applies.

"The same rules should apply to activities which one subsidiary carries on for any other subsidiary of the same company."

C. OBSERVATIONS ON THE OECD COMMENTARY AND RESERVATIONS ON ARTICLE 5 OF THE OECD MODEL CONVENTION

Observations on the commentary

"Treatment in Irish tax law of non-resident operators in *Ireland* and in the Irish continental shelf area. Profits arising to a person not resident in Ireland from exploration or exploitation [p. 75] activities in Ireland or in the Irish continental shelf area as well as profits from exploration or exploitation rights are treated as the profits of a trade carried on in Ireland through a

branch or agency and are, in consequence, taxable in Ireland. This includes non-resident contractors who supply well-drilling, pipe-laying and similar services in Ireland or in the Irish continental shelf area. In addition, capital gains accruing on the disposal of exploration or exploitation rights in Ireland or in the Irish continental shelf area are treated as gains accruing on the disposal of assets situated in Ireland. When negotiating conventions with other Member countries, Ireland would wish subparagraph *(f)* of paragraph 2 to be so drafted and interpreted as to reflect the Irish position.

"*Italy* does not adhere to the interpretation given in paragraph 11 above concerning the list of examples of paragraph 2. In its opinion, these examples can always be regarded as constituting *a priori* permanent establishments.

"While, subject to its reservations in relation to this Article, *New Zealand*, for the purpose of negotiating conventions with other Member countries, accepts, in general, the principles of this Article, it would wish to be free to negotiate for the addition of specific provisions deeming an enterprise in some particular situations to have a permanent establishment in New Zealand."

Reservations on the article

"*Australia* reserves the right to treat an enterprise as having a permanent establishment in a State if the enterprise carries on designated supervisory activities in that State for more than twelve months, if substantial equipment is used in that State for more than twelve months by, for or under contract with the enterprise in the exploration for or exploitation of natural resources, or if a person acting in that State on behalf of the enterprise — manufactures or processes there goods or merchandise belong to the enterprise.

"*Greece, New Zealand, Portugal* and *Turkey* reserve their positions on paragraph 3, and consider that any building site or construction or installation project which lasts more than six months should be regarded as a permanent establishment.

"*New Zealand* also reserves its position so as to be able to tax an enterprise which carries on supervisory activities for more than six months in connection with a building site or construction or installation project lasting more than six months, and also an enterprise where substantial equipment or machinery is for more than six months being used by, for or under contract with the enterprise.

"*Spain* reserves its position on paragraph 3 so as to be able [p. 76] to tax an enterprise having a permanent establishment in Spain, even if the site of the construction or installation project does not last for more than twelve months, where the activity of this enterprise in Spain presents a certain degree of permanency within the meaning of paragraphs 1 and 2."

* * *

[p. 79] Article 7

BUSINESS PROFITS

A. GENERAL CONSIDERATIONS

Article 7 of the United Nations Model Convention consists of a number of provisions of article 7 of the OECD model Convention, either unchanged or substantially amended, and some new provisions. In particular paragraph 5 of article 7 of the OECD text has not been included. The Group of Experts could not reach a consensus on provisions relating to the matters covered by that paragraph and therefore decided to include in article 7 a note indicating that the question of whether profits should be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise should be settled in bilateral negotiations. The members from developing countries considered that that paragraph should not be reproduced in the article, or, if it was included, it should be amended to include a statement to the effect that in the case of a permanent establishment engaged in purchasing and other activities, profits derived from purchasing activities should be attributed to the permanent establishment. Furthermore, some members from developing countries felt that where purchasing constituted the sole activity of an enterprise in the source country, a permanent establishment would exist in that

country, and that since the purchasing activity contributed to the generation of the over-all profit of the enterprise, there should be an allocation of the portion of the over-all profit attributable to the permanent establishment. The members from developed countries believed that it would be desirable to incorporate the provisions of article 7, paragraph 5, in the text of article 7. Details concerning the other amendments to the OECD text and the new provisions are provided below in the commentary on the paragraphs of the article.

The most relevant question in international tax practice concerning business profits relates to the facts which make an enterprise liable to taxation on its profits in a foreign country. There is general acceptance of the so-called "arm's-length" rule embodied in the [p. 80] OECD Draft Model Convention. According to this rule, the profits attributable to a permanent establishment are those which would be earned by the establishment if it were a wholly independent entity dealing with its head office as if it were a distinct and separate enterprise operating under conditions and selling at prices prevailing in the regular market. The profits so attributable are normally the profits shown on the books of the establishment. Nevertheless, this rule permits the authorities of the country in which the permanent establishment is located to rectify the accounts of the enterprise, so as to reflect properly income which the establishment would have earned if it were an independent enterprise dealing with its head office at arm's length. The application of the arm's-length rule to the allocation of profits between the home office and its permanent establishment presupposes for most countries that the domestic legislation authorizes a determination on the basis of the arm's-length principle.

The application of the arm's-length rule is particularly important in connexion with the difficult and complex problem of the deductions to be allowed to the permanent establishment. It is also generally accepted that in calculating the profits of a permanent establishment, allowance should be made for expenses, wherever incurred, for the purposes of the business of the permanent establishment, including executive and general administrative expenses. Apart from what may be regarded as ordinary

expenses, there are some classes of expenditure that give rise to special problems. These include interest and royalties etc. paid by the permanent establishment to its head office in return for money lent or patent rights licensed by the latter to the permanent establishment. They further include commissions (except for the reimbursement of actual expenses) for specific services or for the exercise of management services by the enterprise for the benefit of the establishment. In these cases, it is considered that the payments should not be allowed as deductions in computing the profits of the permanent establishment. Conversely, such payments made to a permanent establishment by the head office should be excluded from the profits of the permanent establishment. On the other hand, an allocable share of such payments, e.g., interest and royalties, paid by the enterprise to third parties should be allowed.

Although according to the OECD Model Convention only profits attributable to the permanent establishment should be taxable in the source country, in some cases the "attribution principle" has been amplified by the so-called "force of attraction" rule, which permits the enterprise, once it carries out business through a permanent establishment in the source country, to be taxed on business profits in that country arising from transactions outside the permanent establishment. Furthermore, non-business income of the enterprise may likewise be attracted into the taxable income of the permanent establishment. Where, owing to the principle of the "force of attraction", [p. 81] the profits of an enterprise other than those attributable directly to the permanent establishment may be taxed in the State where the permanent establishment is situated, such profits should be determined in the same way as if they were attributable directly to the permanent establishment.

It may be recalled that the OECD Model Convention contains the following preliminary remarks on article 7:

"This Article is in many respects a continuation of, and a corollary to, Article 5 on the definition of the concept of permanent establishment. The permanent establishment criterion is commonly used in international double taxation conventions to determine whether a particular kind of income shall or

shall not be taxed in the country from which it originates but the criterion does not of itself provide a complete solution to the problem of the double taxation of business profits; in order to prevent such double taxation it is necessary to supplement the definition of permanent establishment by adding to it an agreed set of rules of reference to which the profits made by the permanent establishment, or by an enterprise trading with a foreign member of the same group of enterprises, are to be calculated. To put the matter in a slightly different way, when an enterprise of a Contracting State carries on business in the other Contracting State the authorities of that second State have to ask themselves two questions before they levy tax on the profits of the enterprise: the first question is whether the enterprise has a permanent establishment in their country; if the answer is in the affirmative the second question is what, if any, are the profits on which that permanent establishment should pay tax. It is with the rules to be used in determining the answer to this second question that Article 7 is concerned. Rules for ascertaining the profits of an enterprise of a Contracting State which is trading with an enterprise of the other Contracting State when both enterprises are members of the same group of enterprises or are under the same effective control are dealt with in Article 9.

"It should perhaps be said at this point that neither Article is strikingly novel or particularly detailed. The question of what criteria should be used in attributing profits to a permanent establishment, and of how to allocate profits from transactions between enterprises under common control, has had to be dealt with in a large number of double taxation conventions and it is fair to say that the solutions adopted have generally conformed to a standard pattern. It is generally recognized that the essential principles on which this standard pattern is based are well founded, and it has been thought sufficient to restate them with some slight amendments and modifications primarily aimed at producing greater clarity. The two Articles incorporate a number [p. 82] of directives. They do not, nor in the nature of things could they be expected to, lay down a series of precise rules for dealing with every kind of problem that may arise when an enterprise of one State makes profits in another.

Modern commerce organizes itself in an infinite variety of ways, and it would be quite impossible within the fairly narrow limits of an article in a double taxation convention to specify an exhaustive set of rules for dealing with every kind of problem that may arise. This, however, is a matter of relatively minor importance, if there is agreement on general lines. Special cases may require special consideration, but it should not be difficult to find an appropriate solution if the problem is approached within the framework of satisfactory rules based on agreed principles."

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 7

Paragraph 1

This paragraph reproduces article 7, paragraph 1, of the OECD Model Convention, with the addition of the provisions contained in clauses (*b*) and (*c*). In the discussion preceding the adoption by the Group of Experts of this paragraph, several members from developing countries expressed support for the "force of attraction" rule, although they would limit the application of that rule to business profits covered by article 7 of the OECD Model Convention and not extend it to income from capital (dividends, interest and royalties) covered by other treaty provisions. The members supporting the application of the "force of attraction" rule also indicated that neither sales through independent commission agents nor purchase activities would become taxable to the principal under that rule. Some members from developed countries pointed out that the "force of attraction" rule had been found unsatisfactory and abandoned in recent tax treaties concluded by them because of the undesirability of taxing income from an activity that was totally unrelated to the establishment and that was in itself not extensive enough to constitute a permanent establishment. They also stressed the uncertainty that such an approach would create for taxpayers. Members from developing countries pointed out that the proposed "force of attraction" approach did remove some administrative problems in that it made it unnecessary to determine whether particular

activities were or were not related to the permanent establishment or the income involved attributable to it. That was the case especially with respect to transactions conducted directly by the home office within the country, but similar in nature to those conducted by the permanent establishment. However, after discussion, it was proposed that the "force of attraction" rule, should be limited so that it would apply to sales of goods or merchandise and other business activities in the following manner: if an enterprise has [p. 83] a permanent establishment in the other Contracting State for the purpose of selling goods or merchandise, sales of the same or a similar kind may be taxed in that State even if they are not conducted through the permanent establishment; a similar rule will apply if the permanent establishment is used for other business activities and the same or similar activities are performed without any connexion with the permanent establishment.

Clauses (*b*) and (*c*) were deemed entirely acceptable by the members from developing countries and a few members from developed countries. Other members from developed countries said that they could accept clauses (*b*) and (*c*) if those clauses were understood not to extend to sales effected by agents of an independent status. Others believed that such an exception would be less acceptable than either the original OECD provision or that provision amended by clauses (*b*) and (*c*). In effect, if that exception were admitted, taxation in the host country would depend upon whether an independent commission agent or broker was involved, which they felt would not be a logical distinction and would, moreover, lend itself to artificial sales arrangements. A few members from developed countries thought that the addition of clauses (*b*) and (*c*) was undesirable and preferred the OECD text.

It may be recalled that the OECD Model Convention contains the following commentary on the provisions of paragraph 1 of article 7 of that Convention.

"This paragraph is concerned with two questions. First, it restates the generally accepted principle of double taxation conventions that an enterprise of one State shall not be taxed in the other State unless it carries on business in that other State through a permanent establishment situated therein. It is hardly necessary to argue here the merits of this principle. It is perhaps sufficient to say that it has come to be accepted in international fiscal matters that until an enterprise of one State sets up a permanent establishment in another State it should not properly be regarded as participating in the economic life of that other State to such an extent that it comes within the jurisdiction of that other State's taxing rights.

"The second and more important point is that it is laid down — in the second sentence — that when an enterprise carries on business through a permanent establishment in another State that State may tax the profits of the enterprise but only so much of them as is attributable to the permanent establishment; in other words that the right to tax does not extend to profits that the enterprise may derive from that State otherwise than through the permanent establishment. This is a question on which there may be differences of view. Some countries have taken the view that when a foreign enterprise has set up a permanent establishment [p. 84] within their territory it has brought itself within their fiscal jurisdiction to such a degree that they can properly tax all profits that the enterprise derives from their territory, whether the profits come from the permanent establishment or from other activities in that territory. But it is thought that it is preferable to adopt the principle contained in the second sentence of paragraph 1, namely that the test that business profits should not be taxed unless there is a permanent establishment is one that should properly be applied not to the enterprise itself but to its profits. To put the matter another way, the principle laid down in the second sentence of paragraph 1 is based on the view that in taxing the profits that a foreign enterprise derives from a particular country, the fiscal authorities of that country should look at the separate sources of profit that the enterprise derives from their country and should apply to each the permanent establishment test. This is of course without prejudice to other articles.

"On this matter, naturally, there is room for differences of view, and since it is an important question it may be useful to set out the arguments for each point of view.

"Apart from the background question of fiscal jurisdiction, the main argument commonly put forward against the solution advocated above is that there is a risk that it might facilitate avoidance of tax. This solution, the argument runs, might leave it open to an enterprise to set up in a particular country a permanent establishment which made no profits, was never intended to make profits, but existed solely to supervise a trade, perhaps of an extensive nature, that the enterprise carried on in that country through independent agents and the like. Moreover, the argument goes, although the whole of this trade might be directed and arranged by the permanent establishment, it might be difficult in practice to prove that was the case. If the rates of tax are higher in that country than they are in the country in which the head office is situated, then the enterprise has a strong incentive to see that it pays as little tax as possible in the other territory; the main criticism of the solution advocated above is that it might conceivably provide the enterprise with a means of ensuring that result.

"Apart again from the question of the proper extent of fiscal jurisdiction, the main argument in favour of the proposed solution is that it is conducive to simple and efficient administration, and that it is more closely adapted to the way in which business is commonly transacted. The organization of modern business is highly complex. In OECD Member countries, there are a considerable number of companies each of which is engaged in a wide diversity of activities and is carrying on business extensively in many countries. It may be that such a company may have set up [p. 85] a permanent establishment in a second country and may be transacting a considerable amount of business through that permanent establishment in one particular kind of manufacture; that a different part of the same company may be selling quite different goods or manufactures in that second country through independent agents; and that the company may have perfectly genuine reasons for taking this course — reasons based on, for example, either on the historical pattern of its business or on commercial convenience. Is it desirable that the fiscal authorities should go so far as to insist on trying to search out the profit element of each of the transactions carried on through independent agents, with a view to aggregating that profit with the profits of the permanent establishment? Such an article might interfere seriously with ordinary commercial processes, and so be out of keeping with the aims of the Convention.

"It is no doubt true that evasion of tax could be practiced by undisclosed channelling of profits away from a permanent establishment and that this may sometimes need to be watched, but it is necessary in considering this point to preserve a sense of proportion and to bear in mind what is said above. It is not, of course, sought in any way to sanction any such malpractice, or to shelter any concern thus evading tax from the consequences that would follow from detection by the fiscal authorities concerned. It is fully recognised that Contracting States should be free to use all methods at their disposal to fight fiscal evasion.

"For the reasons given above, it is thought that the argument that the solution advocated might lead to increase avoidance of tax by foreign enterprises should not be given undue weight. Much more importance is attached to the desirability of interfering as little as possible with existing business organization and of refraining from inflicting demands for information on foreign enterprises which unnecessarily onerous."

Paragraph 2

This paragraph reproduces article 7, paragraph 2, of the OECD Model Convention. In the discussion relating to that paragraph, a member from a developed country pointed out that his country was having some problems with inconsistent determination of the profits properly attributable to a permanent establishment, especially with regard to "turn-key" contracts. It was recalled that under a turn-key contract a contractor agreed to construct a factory or similar facility and make it ready for operation. When the facility was ready for operation, it was handed over to the purchaser, who could then begin operations. The international tax problems occurred when the facility was to be constructed in one country by a contractor resident in [p. 86] another country. The actual construction activities carried on in one country clearly constituted a permanent establishment within that country if of

sufficiently long duration. Turn-key contracts, however, were often concluded before the creation of the permanent establishment and involved many components other than normal construction activities. They also included the purchase of capital goods, the performance of architectural and engineering services and the provision of technical assistance. Those latter items, it was explained, were sometimes completed before construction activities actually started (and hence, before the creation of a permanent establishment at the construction site) and often outside the country in which the construction site/permanent establishment was situated.

The question thus arose how much of the total profits of the turn-key contract was properly attributable to the permanent establishment and thus taxable in the country in which it was situated. A member from a developed country said that he knew of instances in which countries had sought to attribute the entire profits of the contract to the permanent establishment. It was his view, however, that only the profits attributable to activities carried on by the permanent establishment should be taxed in the country in which the permanent establishment was situated, unless the profits included items of income dealt with separately in other articles of the Convention and were taxable in that country accordingly.

The Group recognized that that problem was a complex and potentially controversial one involving many interrelated issues, such as source of income rules and the definitions of permanent establishment and profits of an enterprise. The Group acknowledged that the problem might be considered in the course of bilateral negotiations. Since the discussion resulted in no change in article 7, paragraph 2, of the OECD Model Convention, the whole of the OECD commentary on that paragraph, which reads as follows, is relevant to the United Nations text:

"This paragraph contains the central directive on which the allocation of profits to a permanent establishment is intended to be based. The paragraph incorporates the view, which is generally contained in bilateral conventions, that the profits to be attributed to a permanent establishment are those which that permanent establishment would have made if, instead of dealing with its head office, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. Normally, these would be the same profits that one would expect to be determined by the ordinary processes of good business accountancy. This principle also extends to the allocation of profits which the permanent establishment may derive from transactions with other permanent establishments of the enterprise and with associated companies and their permanent [p. 87] establishments; but Contracting States which consider that the existing paragraph does not in fact cover these more general transactions may, in their bilateral negotiations, agree upon more detailed provisions.

"In the great majority of cases, trading accounts of the permanent establishment — which are commonly available if only because a well-run business organisation is normally concerned to know what is the profitability of its various branches — will be used by the taxation authorities concerned to ascertain the profit properly attributable to that establishment. Exceptionally there may be no separate accounts. . . . But where there are such accounts they will naturally form the starting point for any processes of adjustment in case adjustment is required to produce the amount of properly attributable profits. It should perhaps be emphasized that the directive contained in paragraph 2 is no justification for tax administrations to construct hypothetical profit figures in vacuo; it is always necessary to start with the real facts of the situation as they appear from the business records of the permanent establishment and to adjust as may be shown to be necessary the profit figures which those facts produce. It should also be noted that the principle set out in paragraph 2 is subject to the provisions contained in paragraph 3, especially as regards the treatment of payments which, under the name of interest, royalties, etc. are made by a permanent establishment to its head office in return for money loaned, or patent rights conceded by the latter to the permanent establishment.

"Even where a permanent establishment is able to produce proper accounts which purport to show the profits arising from its activities, it may still be necessary for the taxation authori-

ties of the country concerned to rectify those accounts in accordance with the general directive laid down in paragraph 2. Adjustment of this kind may be necessary, for example, because goods have been invoiced from the head office to the permanent establishment at prices which are not consistent with this directive, and profits have thus been diverted from the permanent establishment to the head office, or vice versa.

"In such cases, it will usually be appropriate to substitute for the prices used ordinary market prices for the same or similar goods supplied on the same or similar conditions. Clearly the price at which goods can be bought on open market terms varies with the quantity required and the period over which they will be supplied; such factors would have to be taken into account in deciding the open market price to be used. It is perhaps only necessary to mention at this point that there may sometimes be perfectly good commercial reasons for an enterprise invoicing its goods at prices less than those prevailing in the ordinary market; [p. 88] this may, for example, be a perfectly normal commercial method of establishing a competitive position in a new market and should not then be taken as evidence of an attempt to divert profits from one country to another. Difficulties may also occur in the case of proprietary goods produced by an enterprise, all of which are sold through its permanent establishments; if in such circumstances there is no open market price, and it is thought that the figures in the accounts are unsatisfactory, it may be necessary to calculate the permanent establishment's profits by other methods, for example, by applying an average ratio of gross profit to the turnover of the permanent establishment and then deducting from the figures so obtained the proper amount of expenses incurred. Clearly many special problems of this kind may arise in individual cases but the general rule should always be that the profits attributed to a permanent establishment should be based on that establishment's accounts insofar as accounts are available which represent the real facts of the situation. If available accounts do not represent the real facts then new accounts will have to be constructed, or the original ones rewritten, and for this purpose the figures to be used will be those prevailing in the open market.

"Some States consider that there is a realisation of a taxable profit when an asset, other than trading stock, forming part of the business property of a permanent establishment situated within their territory is transferred to a permanent establishment or the head office of the same enterprise situated in another State. Article 7 allows such States to tax profits deemed to arise in connexion with such a transfer. Such profits may be determined as indicated in [the preceding four paragraphs]."

Paragraph 3

The first sentence of paragraph 3 of article 7 reproduces the entire text of article 7, paragraph 3, of the OECD Model Convention. The rest of the paragraph consists of new provisions formulated by the Group of Experts. These provisions stem from a proposal by members from developing countries, who felt that it would be helpful to include all the necessary definitions and clarifications in the text, with a view, in particular, to assisting developing countries not represented in the Group. Some of those members also felt that provisions prohibiting the deduction of certain expenses should be included in the text of a bilateral tax treaty to make it clear that taxpayers were fully informed about their fiscal obligations. In the course of the discussion it was pointed out that the additions to the OECD text would ensure that the permanent establishment would be able to deduct interest, royalties and other expenses incurred by the head office on behalf of the establishment. The Group agreed that if billings [p. 89] by the head office included the full costs, both direct and indirect, then there should not be a further allocation of the executive and administrative expenses of the head office, since that would produce a duplication of such charges on the transfer between the head office and the permanent establishment. It was pointed out that it was important to determine how the price was fixed and what elements of cost it included. Where an international wholesale price was used, it would normally include indirect costs. There was general agreement within the Group that any duplication of costs and expenses should be prevented.

Since the first sentence of article 7, paragraph 3, of the United Nations Model Convention reproduces the whole of article 7, paragraph 3, of the OECD Model Convention, the OECD commentary on the latter paragraph, which reads as follows, is relevant to the United Nations text:

"This paragraph clarifies, in relation to the expenses of a permanent establishment, the general directive laid down in paragraph 2. The paragraph specifically recognises that in calculating the profits of a permanent establishment allowance is to be made for expenses, wherever incurred, that were incurred for the purposes of the permanent establishment. Clearly in some cases it will be necessary to estimate or to calculate by conventional means the amount of expenses to be taken into account. In the case, for example, of general administrative expenses incurred at the head office of the enterprise, it may be appropriate to take into account a proportionate part based on the ratio that the permanent establishment's turnover (or perhaps gross profits) bears to that of the enterprise as a whole. Subject to this, it is considered that the amount of expenses to be taken into account as incurred or the purposes of the permanent establishment should be the actual amount so incurred. The deduction allowable to the permanent establishment for any of the expenses of the enterprise attributed to it does not depend upon the actual reimbursement of such expenses by the permanent establishment.

"Apart from what may be regarded as ordinary expenses, there are some classes of payments between permanent establishments and head offices which give rise to special problems, and it is convenient to deal with them at this point. The next paragraphs discuss three specific cases of this kind and give solutions for them. It should not, of course, be inferred that it is only in relation to the three classes of payments mentioned in these paragraphs that problems may arise; there may well be payments of other kinds to which similar considerations apply.

"The first of these cases relates to payments which under the name of interest, royalties, etc. are made by a permanent [p. 90] establishment to its head office in return for money loaned, or patent rights conceded, by the latter to the permanent establishment. In such a case, it is considered that the payments should not be allowed as deductions in computing the permanent establishment's taxable profits. Equally, such payments made to a permanent establishment by the head office should be excluded from the computation of the permanent establishment's taxable profits. It is, however, recognised that special considerations apply to payments of interest made by different parts of a financial enterprise (e.g. a bank) to each other on advances etc. (as distinct from capital allotted to them), in view of the fact that making and receiving advances is narrowly related to the ordinary business of such enterprises. Furthermore, if an enterprise makes payments of interest, etc. to a third party and these payments in part relate to the activities of the permanent establishment, then a proportionate part of them should naturally be taken into account in calculating the permanent establishment's profits insofar as they can properly be regarded as expenses incurred for the purposes of the permanent establishment.

"The second case relates to the performance of ancillary services by a permanent establishment on behalf of its head office or vice versa. Consider, for example, the case of a large company with a varied business, part of which it carries on in another country through a permanent establishment. In addition, that permanent establishment advertises on behalf of its head office goods which that enterprise produces but which the permanent establishment itself does not handle. Clearly, in calculating for tax purposes the profits of the permanent establishment, the profit should be increased by the amount of the expense it has incurred on behalf of the head office (unless, of course, such an adjustment has already been made in drawing up the accounts of the permanent establishment). In fact if the permanent establishment and its head office were entirely separate and independent, the permanent establishment would ordinarily carry out services for the head office only if it were paid a commission as well as reimbursed the actual expenses incurred. It is, therefore, necessary to decide whether the calculation should be made on the basis of account being taken not only of any expenses borne by a permanent establishment by reason of services performed for the head office but also of a

notional commission increasing the profits of the permanent establishment.

"After consideration of this question, it is thought that in such circumstances the profits of the permanent establishment should not be increased by the addition of a 'commission' figure. While, on one view, to include a 'commission' figure in the profits of every permanent establishment that has performed services [p. 91] otherwise than for its own purposes could be looked at in theory as a consequential application of the fiction of separate enterprise, it would inevitably be found exceedingly cumbersome in practice. There would be scope for lengthy argument about, and usually no concrete basis for determining, the percentage to be used in calculating the amount of notional 'commission'. In the great majority of cases the accounts of the permanent establishment would doubtless take into consideration actual expenses incurred; in other words they would not normally include any credit for 'commission'. If as a general rule the 'separate enterprise' test were to be applied to services performed by a permanent establishment on behalf of its head office and a notional 'commission' profit were to be included in the profits of the permanent establishment, it would, therefore, be necessary in the great majority of cases first to settle how the 'commission' element was to be calculated and then re-write the accounts of the permanent establishment. Considerations of practical administration weigh heavily against such a course. Therefore no 'commission' element should in such cases be included in the profits of the permanent establishment. Similarly, in the converse case where the head office undertakes services on behalf of the permanent establishment, no 'commission' element should be deducted in determining the profits of the permanent establishment.

"The third case is related to the question whether any part of the total profits of an enterprise should be deemed to arise from the exercise of good management. Consider the case of a company that has it head office in one country but carries on all its business through a permanent establishment situated in another country. In the extreme case it might well be that only the directors' meetings were held at the head office and that all

other activities of the company, apart from purely formal legal activities, were carried on in the permanent establishment. In such a case there is something to be said for the view that at least part of the profits of the whole enterprise arose from the skilful management and business acumen of the directors and that part of the profits of the enterprise ought, therefore, to be attributed to the country in which the head office was situated. If the company has been managed by a managing agency, then that agency would doubtless have charged a fee for is services and the fee might well have been a simple percentage participation in the profits of the enterprise. But, once again, whatever the theoretical merits of such a course, practical considerations weigh heavily against it. In the kind of case quoted the expenses of management would, of course, be set against the profits of the permanent establishment in accordance with the provisions of paragraph 3, but when the matter is looked at as a whole, it is thought that it would not be right to go further by deducting and taking into account some [p. 92] notional figure for 'profits of management'. In cases identical to the extreme case mentioned above, no account should therefore be taken in determining taxable profits of the permanent establishment of any notional figure such as profits of management.

"It may be, of course, that countries where it has been customary to allocate some proportion of the total profits of an enterprise to the head office of the enterprise to represent the profits of good management will wish to continue to make such an allocation. Nothing in the article is designed to prevent this. Nevertheless it follows from what is said in the above paragraph that a country in which a permanent establishment is situated is in no way required to deduct when calculating the profits attributable to that permanent establishment an amount intended to represent a proportionate part of the profits of management attributable to the head office.

"It might well be that if the country in which the head office of an enterprise is situated allocates to the head office some percentage of the profits of the enterprise only in respect of good management, while the country in which the permanent establishment is situated does not, the resulting total of the

amounts charged to tax in the two countries would be greater than it should be. In any such case the country in which the head office of the enterprise is situated should take the initiative in arranging for such adjustments to be made in computing the taxation liability in that country as may be necessary to ensure that any double taxation is eliminated.

"It is usually found that there are, or there can be constructed, adequate accounts for each part or section of an enterprise so that profits and expenses, adjusted as may be necessary, can be allocated to a particular part of the enterprise with a considerable degree of precision. This method of allocation is, it is thought, to be preferred in general wherever it is reasonably practicable to adopt it. There are, however, circumstances in which this may not be the case and paragraphs 2 and 3 are in no way intended to imply that other methods cannot properly be adopted where appropriate in order to arrive at the profits of a permanent establishment on a 'separate enterprise' footing. It may well be, for example, that profits of insurance enterprises can most conveniently be ascertained by special methods of computation, e.g. by applying appropriate coefficients to gross premiums received from policy holders in the country concerned. Again, in the case of a relatively small enterprise operating on both sides of the (b) order between two countries, there may be no proper accounts for the permanent establishment nor means of constructing them. There may, too, be other cases where the affairs of the permanent establishment are so closely bound up [p. 93] with those of the head office that it would be impossible to disentangle them on any strict basis of branch accounts. Where it has been customary in such cases to estimate the arm's length profit of a permanent establishment by reference to suitable criteria, it may well be reasonable that that method should continue to be followed notwithstanding that the estimate thus made may not achieve as high a degree of accurate measurement of the profit as adequate accounts. Even where such a course has not been customary, it may, exceptionally, be necessary for practical reasons to estimate the arm's length profits."

Some countries wished to point out that they allowed only those deductions that were permitted by their domestic laws.

Paragraph 4

This paragraph reproduces article 7, paragraph 4, of the OECD Model Convention. The OECD commentary on the latter paragraph, which reads as follows, is therefore relevant to the United Nations text:

"It has in some cases been the practice to determine the profits to be attributed to a permanent establishment not on the basis of separate accounts or by making an estimate of arm's length profit, but simply by apportioning the total profits of the enterprise by reference to various formulae. Such a method differs from those envisaged in paragraph 2, since it contemplates not an attribution profits on a separate enterprise footing, but an apportionment of total profits; and indeed it might produce a result in figures which would differ from that which would be arrived at by a computation based on separate accounts. Paragraph 4 makes it clear that such a method may continue to be employed by a Contracting State if it has been customary in that State to adopt it, even though the figure arrived at may at times differ to some extent from that which would be obtained from separate accounts, provided that the result can fairly be said to be in accordance with the principles contained in the article. It is emphasized, however, that in general the profits to be attributed to a permanent establishment should be determined by reference to the establishment's accounts if these reflect the real facts. It is considered that a method of allocation which is based on apportioning total profits is generally not as appropriate as a method which has regard only to the activities of the permanent establishment and should be used only where exceptionally it has as a matter of history been customary in the past and is accepted in the country concerned both by the taxation authorities and taxpayers generally there as being satisfactory. It is understood that paragraph 4 may be deleted where neither State uses such a method. Where, however, Contacting States which to be able to [p. 94] use a method which was not been customary in the

past the paragraph should be amended during the bilateral negotiations to make this clear.

"It would not, it is thought, be appropriate within the framework of this Commentary to attempt to discuss at length the many various methods involving apportionment of total profits that have been adopted in particular fields for allocating profits. These methods have been well documented in treaties on international taxation. It may, however, not be out of place to summarize briefly some of the main types and to lay down some very general directives for their use.

"The essential character of a method involving apportionment of total profits is that a proportionate part of the profits of the whole enterprise is allocated to a part thereof, all parts of the enterprise being assumed to have contributed on the basis of the criterion or criteria adopted to the profitability of the whole. The difference between one such method and another arises for the most part from the varying criteria used to determine what is the correct proportion of the total profits. It is fair to say that the criteria commonly used can be grouped into three main categories, namely those which are based on the receipts of the enterprise, its expenses or its capital structure. The first category covers allocation methods based on turnover or on commission, the second on wages and the third on the proportion of the total working capital of the enterprise allocated to each branch or part. It is not, of course, possible to say in vacuo that any of these methods is intrinsically more accurate than the others; the appropriateness of any particular method will depend on the circumstances to which it is applied. In some enterprises, such as those providing services or producing proprietary articles with a high profit margin, net profits will depend very much on turnover. For insurance enterprises it may be appropriate to make an apportionment of total profits by reference to premiums received from policy holders in each of the countries concerned. In the case of an enterprise manufacturing goods with a high cost raw material or labour content, profits may be found to be related more closely to expenses. In the case of banking and financial concerns the proportion of total working capital may be the most relevant criterion. It is

considered that the general aim of any method involving apportionment of total profits ought to be to produce figures of taxable profit that approximate as closely as possible to the figures that would have been produced on a separate accounts basis, and that it would not be desirable to attempt in this connection to lay down any specific directive other than that it should be the responsibility of the taxation authority, in consultation with the authorities of other countries concerned, to use [p. 95] the method which in the light of all the known facts seems most likely to produce that result.

"The use of any method which allocates to a part of an enterprise a proportion of the total profits of the whole does, of course, raise question of the method to be used in computing the total profits of the enterprise. This may well be a matter which will be treated differently under the laws of different countries. This is not a problem which it would seem practicable to attempt to resolve by laying down any rigid rule. It is scarcely to be expected that it would be accepted that the profits to be apportioned should be the profits as they are computed under the laws of one particular country; each country concerned would have to be given the right to compute the profits according to the provisions of its own laws."

Paragraph 5

This paragraph reproduces article 7, paragraph 6, of the OECD Model Convention. In the words of the OECD commentary, the paragraph "is intended to lay down clearly that a method of allocation once used should not be changed merely because in a particular year some other method produces more favorable results. One of the purposes of a double taxation convention is to give an enterprise of a Contracting State some degree of certainty about the tax treatment that will be accorded to its permanent establishment in the other Contracting State as well as to the part of it in its home State which is dealing with the permanent establishment; for this reason, paragraph 6 gives an assurance of continuous and consistent tax treatment."

Paragraph 6

This paragraph reproduces article 7, paragraph 7, of the OECD Model Convention. The commentary on that paragraph is therefore relevant to article 7, paragraph 6, of the United Nations Model Convention. The commentary reads as follows:

"Although it has not been found necessary in the Convention to define the term 'profits', it should nevertheless be understood that the term when used in this Article and elsewhere in the Convention has a broad meaning including all income derived in carrying on an enterprise. Such a broad meaning corresponds to the use of the term made in the tax laws of most OECD Member countries.

"This interpretation of the term profits, however, may give rise to some uncertainty as to the application of the Convention. If the profits of an enterprise include categories of income which are treated separately in other articles of the Convention, e.g. [p. 96] dividends, it may be asked whether the taxation of those profits is governed by the special Article on dividends etc., or by the provisions of this Article.

"To the extent that an application of this Article and the special Article concerned would result in the same tax treatment, there is little practical significance to this question. Further, it should be noticed that some of the special Articles contain specific provisions giving priority to a specific article (cf. paragraph 4 of Article 6, paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12 and paragraph 2 of Article 21).

"It has seemed desirable, however, to lay down a rule of interpretation in order to clarify the field of application of the present Article in relation to the other Articles dealing with a specific category of income. In conformity with the practice generally adhered to in existing bilateral conventions, paragraph 7 gives first preference to the special Articles on dividends interest etc. It follows from the rule that this article will be applicable to industrial and commercial income which does not belong to categories of income covered by the special articles, and, in addition, to dividends, interest etc. which under paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12

and paragraph 2 of Article 21 fall within this article. It is understood that the items of income covered by the special Articles may, subject to the provisions of the Convention, be taxed either separately, or as industrial and commercial profits, in conformity with the tax laws of the Contracting States.

"It is open to Contracting States to agree bilaterally upon special explanations or definitions concerning the term 'profits' with a view to clarifying the distinction between this term and e.g. the concept of dividends. It may in particular be found appropriate to do so where in a convention under negotiation a deviation has been made from the definitions in the special Articles on dividends, interest and royalties. It may also be deemed desirable if the Contracting States wish to place on notice, that, in agreement with the domestic tax laws of one or both of the States, the term 'profits' includes special classes of receipts such as income from the alienation or the letting of a business or of movable property used in a business. In this connexion it may have to be considered whether it would be useful to include also additional rules for the allocation of such special profits."

C. OBSERVATIONS ON THE OECD COMMENTARY AND RESERVATIONS ON ARTICLE 7 OF THE OECD MODEL CONVENTION

Observations on the commentary

"*Australia and New Zealand* would wish to be free to propose in bilateral negotiations a provision to the effect that, if the [p. 97] information available to the competent authority of a Contracting State is inadequate to determine the profits to be attributed to the permanent establishment of an enterprise, the competent authority may apply to that enterprise for that purpose the provisions of the taxation law of that State, subject to the qualification that such law will be applied, so far as the information available to the competent authority permits, in accordance with the principles of this Article.

"*Australia* would wish that in this Article there be provision that will permit resort to domestic law in relation to the taxation of the profit of an insurance enterprise.

"While *New Zealand*, for the purpose of negotiating conventions with other Member countries, accepts, in general, the principles of this Article relating to the attribution of profits to a permanent establishment, it would wish to be free to negotiate for the inclusion of specific provision governing the basis of attribution in some particular situations."

Reservations on the article

"*New Zealand* reserves the right to exclude from the scope of this Article income from the business of any form of insurance.

"The *United States* believes it appropriate to provide in paragraph 2 for arm's length treatment not only with the head office of the enterprise, but also with any person controlling, controlled by, or subject to the same common control as, the enterprise. This can be accomplished by changing the phrase 'separate enterprise' to 'independent enterprise' and by deleting the last fourteen words."

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[p. 105] *Article 9*

ASSOCIATED ENTERPRISES

A. GENERAL CONSIDERATIONS

Article 9 of the United Nations Model Convention reproduces article 9 of the OECD Model Convention.

This article deals with associated enterprises, i.e., parent and subsidiary companies and companies under common control. It should be considered in conjunction with article 25 on mutual agreement procedure and article 26 on exchange of information, just as article 9 of the OECD Model Convention has to be considered with articles 25 and 26 of that Convention.

The application of the arm's-length rule to the allocation of profits between the home office and its permanent establishment [p. 106] presupposes for most countries that the domestic legislation authorizes a determination on the basis of the arm's-length principle.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 9

Paragraph 1

Under this paragraph, as under article 9, paragraph 1, of the OECD Model Convention, the tax authorities of a Contracting State may, for the purpose of calculating tax liabilities, in the words of the OECD commentary on that paragraph "re-write the accounts of the enterprises if as a result of the special relations between the enterprises the accounts do not show the true taxable profits arising in that State". After observing that "it is evidently appropriate that adjustment should be sanctioned in such circumstances", the commentary states: "It should perhaps be mentioned that the provisions of this paragraph apply only if special conditions have been made or imposed between the two enterprises. No re-writing of the accounts of associated enterprises is authorised if the transactions between such enterprises have taken place on normal open market commercial terms (on an arm's-length basis)."

Paragraph 2

In the words of the commentary on article 9, paragraph 2, of the OECD Model Convention, "The re-writing of transactions between associated enterprises in the situation envisaged in paragraph 1 may give rise to economic double taxation (taxation of the same income in the hands of different person), in so far as an enterprise of State A whose profits are revised upwards will be liable to tax on an amount of profit which has already been taxed in the hands of its associated enterprise in State B." The OECD commentary observes that "paragraph 2 provides that in these circumstances, State B shall make an appropriate adjustment so as to relieve the double taxation". The remainder of the commen-

tary on article 9, paragraph 2, of the OECD Model Convention reads as follows:

"It should be noted, however, that an adjustment is not automatically to be made in State B simply because the profits in State A have been increased; the adjustment is due only if State B considers that the figure of adjusted profits correctly reflects what the profits would have been if the transactions had been at arm's length. In other words, the paragraph does not seek to avoid a double charge to tax which arises where the profits of one associated enterprise are increased to a level which exceeds what they would have been if they had been correctly computed on an arm's-length basis. State B is therefore committed to make an adjustment of the profits of the affiliated company only if it [p. 107] considers that the adjustment made in State A is justified both in principle and as regards the amount.

"The paragraph does not specify the method by which an adjustment is to be made. OECD Member countries use different methods to provide relief in these circumstances and it is therefore left open for Contracting States to agree bilaterally on any specific rules which they wish to add to the Article. Some States, for example, would prefer the system under which, where the profits of enterprise X in State A are increased to what they would have been on an arm's length basis, the adjustment would be made by re-opening the assessment on the associated enterprise Y in State B containing the doubly taxed profits in order to reduce the taxable profit by an appropriate amount. Some other States, on the other hand, would prefer to provide that, for the purposes of article 23, the doubly taxed profits should be treated in the hands of enterprise Y of State B as if they may be taxed in State A; accordingly, the enterprise of State B is entitled to relief in State B, under Article 23, in respect of tax paid by its associate enterprise in State A.

"It is not the purpose of the paragraph to deal with what might be called 'secondary adjustments'. Suppose that an upward revision of taxable profits of enterprise X in State A has been made in accordance with the principle laid down in

paragraph 1; and suppose also that an adjustment is made to the profits of enterprise Y in State B in accordance with the principle laid down in paragraph 2. The position has still not been restored exactly to what it would have been had the transactions taken place at arm's-length prices because, as a matter of fact, the money representing the profits which are the subject of the adjustment is found in the hands of enterprise Y instead of in those of enterprise X. It can be argued that if an arm's-length pricing had operated and enterprise X had subsequently wished to transfer these profits to enterprise Y, it would have done so in the form of, for example, a dividend or a royalty (if enterprise Y were the parent of enterprise X) or in the form of, for example, a loan (if enterprise X were the parent of enterprise Y); and that in those circumstances there could have been other tax consequences (e.g. the operation of a withholding tax) depending upon the type of income concerned and the provisions of the article dealing with such income.

"These secondary adjustments, which would be required to establish the situation exactly as it would have been if transactions had been at arm's length, depend on the facts of the individual case. It should be noted that nothing in paragraph 2 prevents such secondary adjustments from being made where they are permitted under the domestic laws of Contracting States.

[p. 108] "The paragraph also leaves open the question whether there should be a period of time after the expiration of which State B would not be obliged to make an appropriate adjustment to the profits of enterprise Y following an upward revision of the profits of enterprise X in State A. Some States consider that State B's commitment should be open-ended — in other words, that however many years State A goes back to revise assessments, enterprise Y should in equity be assured of an appropriate adjustment in State B. Other States consider that an open-ended commitment of this sort is unreasonable as a matter of practical administration. In the circumstances, therefore, this problem has not been dealt with in the text of the Article; but Contracting States are left free in bilateral conventions to include, if they wish, provisions dealing with the

length of time during which State B is to be under obligation to make an appropriate adjustment.

"If there is a dispute between the interested parties over the character and amount of the appropriate adjustment, the matter will be dealt with in the same way as any other question of fact; if necessary the competent authorities may consult each other."

C. OBSERVATIONS ON THE OECD COMMENTARY AND RESERVATIONS ON ARTICLE 9 OF THE OECD MODEL CONVENTION

Observations on the commentary

"In negotiating conventions with other Member countries, *Australia* and *New Zealand* would wish to be free to propose a provision to the effect that, if the information available to the competent authority of a Contracting State is inadequate to determine the profits to be attributed to an enterprise, the competent authority may apply to that enterprise for that purpose the provisions of the taxation law of that State, subject to the qualification that such law will be applied, as far as the information available to the competent authority permits, in accordance with the principles of this Article.

"*Australia* would wish that, in this Article, there be provision that will permit resort to domestic law in relation to the taxation of the profits of an insurance enterprise."

Reservations on the article

"*Belgium, Finland, Germany, Italy, Japan, Portugal* and *Switzerland* reserve the right not to insert paragraph 2 in their conventions.

"The *United States* believes that this Article should apply to all related persons, not just an enterprise of one Contracting State [p. 109] and a related enterprise of the other Contracting State, and that it should apply to 'income, deductions, credits or allowances', not just to 'profits'."

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[p. 207] Commentaries on chapter VI

SPECIAL PROVISIONS

Article 24

Non-Discrimination

A. GENERAL CONSIDERATIONS

Article 24 of the United Nations Model Convention reproduces article 24 of the OECD Model Convention.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 24

Paragraph 1

Since this paragraph reproduces article 24, paragraph 1, of the OECD Model Convention, the commentary on that paragraph is fully relevant:

"This paragraph establishes the principle that for purposes of taxation discrimination on the grounds of nationality is forbidden, and that, subject to reciprocity, the nationals of a Contracting State may not be less favourably treated in the other Contracting State than nationals of the latter State in the same circumstances.

"It is noteworthy that the principle of non-discrimination, under various descriptions and with a more or less wide scope, was applied in international fiscal relations well before the appearance, at the end of the 19th Century, of the classic type of double taxation conventions. Thus, in a great many agreements of different kinds (consular or establishment conventions, treaties of friendship or commerce, etc.) concluded by States, especially in the 19th Century, in order to extend and strengthen the diplomatic protection of their nationals wherever resident, there are clauses under which each of the two Contracting States undertakes to accord nationals of the other State equality of treatment with their own nationals. The fact such clauses subsequently found their way into double taxation conventions has in no way affected their original justification and scope. The text of paragraph 1 provides that the application

of this paragraph is not restricted by article 1 to nationals solely who are residents of a Contracting State, but on the contrary, extends to all nationals of each Contracting State, whether or not they be residents of one [p. 208] of them. In other words, all nationals of a Contracting State are entitled to invoke the benefit of this provision as against the other Contracting State. This holds good, in particular, for nationals of the Contracting States who are not residents of either of them but of a third State.

"The expression 'in the same circumstances' refers to taxpayers (individuals, legal persons, partnerships and associations) placed, from the point of view of the application of the ordinary taxation laws and regulations, in substantially similar circumstances both in law and in fact.

"Consequently if a Contracting State, in giving relief from taxation on account of family responsibilities, distinguishes between its own nationals according to whether they reside in its territory or not, that State cannot be obliged to give nationals of the other State who do not reside in its territory the same treatment as it gives its resident nationals but it undertakes to extend to them the same treatment as is available to its non-resident nationals.

"Likewise, the provisions of paragraph 1 are not to be construed as obliging a State which accords special taxation privileges to its own public bodies or services as such, to extend the same privileges to the public bodies and services of the other State.

"Neither are they to be construed as obliging a State which accords special taxation privileges to private institutions not for profit whose activities are performed for purposes of public benefit, which are specific to that State to extend the same privileges to similar institutions whose activities are not for its benefit.

"To take the first of these two cases, if a State accords immunity from taxation to its own public bodies and services, this is justified because such bodies and services are integral parts of the State and at no time can their circumstances be

comparable to those of the public bodies and services of the other State. Nevertheless, this reservation is not intended to apply to State corporations carrying on gainful undertakings. To the extent that these can be regarded as being on the same footing as private industrial and commercial undertakings, the provisions of paragraph 1 will apply to them.

"As for the second case, if a State accords taxation privileges to certain private institutions not for profit, this is clearly justified by the very nature of these institutions' activities and by the benefit which that State and its nationals will derive from those activities.

"Furthermore, paragraph 1 has been deliberately framed in a negative form. By providing that the nationals of a Contracting [p. 209] State may not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of the other Contracting State in the same circumstances are or may be subjected, this paragraph has the same mandatory force as if it enjoined the Contracting States to accord the same treatment to their respective nationals. But since the principal object of this clause is to forbid discrimination in one State against the nationals of the other, there is nothing to prevent the first State from granting to persons of foreign nationality, for special reasons of its own, or in order to comply with a special stipulation in a double taxation convention, such as, notably, the requirement that profits of permanent establishments are to be taxed on the basis of separate accounts, certain concessions or facilities which are not available to its own nationals. As it is worded, paragraph 1 would not prohibit this.

"Subject to the foregoing observation, the words '... shall not be subjected ... to any taxation or any requirement connected therewith which is other or more burdensome ...' mean that when a tax is imposed on nationals and foreigners in the same circumstances, it must be in the same form as regards both the basis of charge and the method of assessment, its rate must be the same and, finally, the formalities connected with

the taxation (returns, payment, prescribed times, etc.) must not be more onerous for foreigners than for nationals."

Paragraph 2

Since this paragraph reproduces article 24, paragraph 2, of the OECD Model Convention, the commentary on that paragraph is fully relevant:

"Paragraph 2 merely stipulates that the term 'nationals' applies to all individuals possessing the nationality of a Contracting State. It has not been judged necessary here to introduce into the text of the article any considerations on the signification of the concept of nationality, any more than it seemed indispensable to make any special comment here on the meaning and application of the word. Obviously, in determining in relation to individuals, what is meant by 'the nationals of a Contracting State', reference must be made to the sense in which the term is usually employed and each State's particular rules on the acquisition or loss of nationality.

"But paragraph 2 is more specific as to legal persons, partnerships and associations. By declaring that all legal persons, partnerships and associations deriving their status as such from the laws in force in a Contracting State are considered to be nationals for the purposes of paragraph 1, the provision disposes [p. 210] of a difficulty which often arises in determining the nationality of companies. In defining the nationality of companies, certain States have regard less to the law which governs the company than to the origin of the capital with which the company was formed or the nationality of the individuals or legal persons controlling it.

"Moreover, in view of the legal relationship created between the company and the State under whose law it is constituted, which from certain points of view is closely akin to the relationship of nationality in the case of individuals, it seems justifiable not to deal with legal persons, partnerships and associations in a special provision, but to assimilate them with individuals under the term 'nationals'."

Paragraph 3

Since this paragraph reproduces article 24, paragraph 3, of the OECD Model Convention, the commentary on the latter paragraph, which reads as follows, is fully relevant:

"On 28th September, 1954, a number of States concluded in New York a Convention relating to the status of stateless persons, under article 29 of which stateless persons must be accorded national treatment. The signatories of the Convention include several OECD Member countries.

"It should, however, be recognized that the provisions of paragraph 3 will, in a bilateral convention, enable national treatment to be extended to stateless persons who, because they are in one of the situations enumerated in paragraph 2 of article 1 of the above-mentioned Convention of 28th September, 1954, are not covered by that Convention. This is mainly the case, on the one hand, of persons receiving at the time of signature of that Convention, protection or assistance from organs or agencies of the United Nations other than the United Nations High Commissioner for Refugees, and, on the other hand, of persons who are residents of a country and who there enjoy and are subject to the rights and obligations attaching to the possession of that country's nationality.

"The purpose of paragraph 3 is to limit the scope of the clause concerning equality of treatment with nationals of a Contracting State solely to stateless persons who are residents of that or the other Contracting State.

"By thus excluding stateless persons who are residents of neither Contracting State, such a clause prevents their being privileged in one State as compared with nationals of the other state.

"However, if States were to consider it desirable in their [p. 211] bilateral relations, to extend the application of paragraph 3 to all stateless persons, whether residents of a Contracting State or not, so that in all cases they enjoy the most favourable treatment accorded to nationals of the State concerned, in order to do this they would need only to adopt the

following text which contains no condition as to residence in a Contracting State:

" 'Notwithstanding the provisions of Article 1, stateless persons shall not be subjected in a Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that State in the same circumstances are or may be subjected'.

"It is possible that in the future certain States will take exception to the provisions of paragraph 3 as being too liberal insofar as they entitle stateless persons who are residents of one State to claim equality of treatment not only in the other State but also in their State of residence and thus benefit in particular in the latter from the provisions of double taxation conventions concluded by it with third States. If such States wished to avoid this latter consequence, they would have to modify paragraph 3 as follows:

" 'Stateless persons who are residents of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected herewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected.'

"Finally, it should be understood that the definition of the term 'stateless person' to be used for the purposes of such a clause can only be that laid down in paragraph 1 of Article 1 of the Convention of 28th September, 1954, which defines a stateless person as 'a person who is not considered as a national by any State under the operation of its law'."

Paragraph 4

Since this paragraph reproduces article 24, paragraph 4, of the OECD Model Convention, the commentary on that paragraph is fully relevant:

"Strictly speaking, the type of discrimination which this paragraph is designed to end is discrimination based not on

nationality but on the actual situs of an enterprise. It therefore affects without distinction, and irrespective of their nationality, all residents of a Contracting State who have a permanent establishment in the other Contracting State.

"It appears necessary first to make it clear that the wording [p. 212] of the first sentence of paragraph 4 must be interpreted in the sense that it does not constitute discrimination to tax non-resident persons differently, for practical reasons, from resident persons, as long as this does not result in more burdensome taxation for the former than for the latter. In the negative form in which the provision concerned has been framed, it is the result alone which counts, it being permissible to adapt the mode of taxation to the particular circumstances in which the taxation is levied.

"By the terms of the first sentence of paragraph 4, the taxation of a permanent establishment shall not be less favourably levied in the State concerned than the taxation levied on enterprises of that State carrying on the same activities. The purpose of this provision is to end all discrimination in the treatment of permanent establishments as compared with resident enterprises belonging to the same sector of activities, as regards taxes based on industrial and commercial activities, and especially taxes on business profits.

"However, the second sentence of paragraph 4 specifies the conditions under which the principle of equal treatment set forth in the first sentence should be applied to individuals who are residents of a Contracting State and have a permanent establishment in the other State. It is designed mainly to ensure that such persons do not obtain greater advantages than residents, through entitlement to personal allowances and reliefs for family responsibilities, both in the State of which they are residents, by the application of its domestic laws, and in the other State by virtue of the principle of equal treatment. Consequently, it leaves it open to the State in which the permanent establishment is situated whether or not to give personal allowances and reliefs to the persons concerned in the proportion which the amount of the permanent establishment's profits bears to the world income taxable in the other State.

"As regards the first sentence, experience has shown that it was difficult to define clearly and completely the substance of the principle of equal treatment and this has led to wide differences of opinion with regard to the many implications of this principle. The main reason for difficulty seems to reside in the actual nature of the permanent establishment which is not a separate legal entity but only a part of an enterprise that has its head office in another State. The situation of the permanent establishment is different from that of a domestic enterprise, which constitutes as single entity all of whose activities, with their fiscal implications, can be fully brought within the purview of the State where it has its head office. The implications of the equal treatment clause will be examined below under several aspects of the levying of tax.

[p. 213] "A. *Assessment of tax*

"With regard to the basis of assessment of tax, the principle of equal treatment normally has the following implications:

"(*a*) Permanent establishments must be accorded the same right as resident enterprises to deduct the trading expenses that are, in general, authorized by the taxation law to be deducted from taxable profits in addition to the right to attribute to the permanent establishment a proportion of the overheads of the head office of the enterprise. Such deductions should be allowed without any restrictions other than those also imposed on resident enterprises.

"(*b*) Permanent establishments must be accorded the same facilities with regard to depreciation and reserves. They should be entitled to avail themselves without restriction not only of the depreciation facilities which are customarily available to enterprises (straight line depreciation, declining balance depreciation), but also of the special systems that exist in a number of countries ('wholesale' writing down, accelerated depreciation, etc.). As regards reserves, it should be noted that these are sometimes authorised for purposes other than the offsetting — in accordance with commercial accounting principles — of depreciation on assets, expenses or losses which have not yet

occurred but which circumstances make likely to occur in the near future. Thus, in certain countries, enterprises are entitled to set aside, out of taxable profit provisions or 'reserves' for investment. When such a right is enjoyed by all enterprises, or by all enterprises in a given sector of activity, it should normally also be enjoyed, under the same conditions, by non-resident enterprises, or by all enterprises in a given sector of activity, it should in the State concerned insofar, that is, as the activities to which such provisions or reserves would pertain are taxable in that State.

"(*c*) Permanent establishments should also have the option that is available in most countries to resident enterprises of carrying forward or backward a loss brought out at the close of an accounting period within a certain period of time (e.g. 5 years). It is hardly necessary to specify that in the case of permanent establishments it is the loss on their own business activities, as shown in the separate accounts for these activities, which will qualify for such carry-forward.

"(*d*) Permanent establishments should further have the same rules applied to resident enterprises, with regard to the taxation of capital gains realised on the alienation of assets, whether during or on the cessation of business.

"Although the general rules mentioned above rarely give rise to any difficulties with regard to the principle of nondiscrimination, the same does not always hold good for the tax [p. 214] incentive measures which most countries, faced with such problems as decentralization of industry, development of economically backward regions, or the promotion of new activities necessary for the expansion of the economy, have introduced in order to facilitate the solution of these problems by means of tax exemptions, reductions or other tax advantages given to enterprises for investment which is in line with official objectives.

"As such measures are in furtherance of objectives directly related to the economic activity proper of the State concerned, it is right that the benefit of them should be extended to permanent establishments of enterprises of another State which

has a double taxation convention with the first embodying the provisions of Article 24, once they have been accorded the right to engage in industrial or commercial activity in that State, either under its legislation or under an international agreement (treaties of commerce, establishment conventions, etc.) concluded between the two States.

"It should, however, be noted that although non-resident enterprises are entitled to claim these tax advantages in the State concerned, they must fulfil the same conditions and requirements as resident enterprises. They may, therefore, be denied such advantages if their permanent establishments are unable or refuse to fulfil the special conditions and requirements attached to the granting of them.

"Finally, it goes without saying that non-resident enterprises are not entitled to tax advantages attaching to activities the exercise of which is strictly reserved, on grounds of national interest, defence, protection of the national economy, etc., to domestic enterprises, since non-resident enterprises are not allowed to engage in such activities.

"B. Special treatment of dividends received in respect of holdings owned by permanent establishments

"In many countries special rules exist for the taxation of dividends distributed between companies (parent company-subsidiary treatment, the 'Schachtelprivileg', the rule 'non bis in idem'). The question arises whether such treatment should by effect of the provisions of paragraph 4 also be enjoyed by permanent establishments in respect of dividends on holdings forming part of their assets.

"On this point opinions differ. Some States consider that such special treatment should be accorded to permanent establishments. They take the view that such treatment was enacted in order to avoid double taxation on profits made by a subsidiary and distributed to a parent company. In principle profits tax [p. 215] should be levied once, in the hands of the subsidiary performing the profit-generating activities. The parent company should be exempted from tax on such profits when received

from the subsidiary or should, under the indirect credit method, be given relief for the taxation borne by the subsidiary. In cases where shares are held as direct investment by a permanent establishment the same principle implies that such a permanent establishment receiving dividends from the subsidiary should likewise be granted the special treatment in view of the fact that a profits tax has already been levied in the hands of the subsidiary. On the other hand, it is hardly conceivable on this line of thought to leave it to the State where the head office of the parent company is situated to give relief from double taxation brought about by a second levying of tax in the State of the permanent establishment. The state of the parent company, in which no activities giving rise to the doubly taxed profits have taken place, will normally exempt the profits in question or will levy a profits tax which is not sufficient to bear a double credit (i.e. for the profits tax on the subsidiary as well as for such tax on the permanent establishment). All this assumes that the shares held by the permanent establishment are effectively connected with its activity. Furthermore, an obvious additional condition is that the profits out of which the dividends are distributed should have borne a profits tax.

"Other States, on the contrary, consider that assimilating permanent establishments to their own enterprises does not entail any obligation to accord such special treatment to the former. They justify their position on various grounds. The purpose of such special treatment is to avoid economic double taxation of dividends and it should be for the recipient company's State of residence and not the permanent establishment's State to bear its cost, because it is more interested in the aim in view. Another reason put forward related to the sharing of tax revenue between States. The loss of tax revenue incurred by a State in applying such special treatment is partly offset by the taxation of the dividends when they are redistributed by the parent company which has enjoyed such treatment (withholding tax on dividends, shareholder's tax). A State which accorded such treatment to permanent establishments would not have the benefit of such a compensation. Another argument made is that when such treatment is made conditional upon redistribution of the dividends its extension to permanent

establishments would not be justified, for in such a case the permanent establishment, which is only a part of a company of another State and does not distribute dividends, would be more favourably treated than a resident company. Finally, the States which feel that paragraph 4 does not entail any obligation to extend such treatment to permanent establishments [p. 216] argue that there is a risk that companies of one State might transfer their holdings in companies of another State to their permanent establishments in that other State for the sole purpose of availing themselves of such treatment.

"The fact remains that there can be very valid reasons for a holding being owned and managed by a permanent establishment rather than by the head office of the enterprise, viz.,

"— reasons of necessity arising principally from a legal or regulatory obligation on banks and financial institutions and insurance companies to keep deposited in countries where they operate a certain amount of assets, particularly shares, as security for the performance of their obligations;

"— or reasons of expediency, where the holdings are in companies which have business relations with the permanent establishment or whose head offices are situated in the same country as the permanent establishment;

"— or simple reason of practical convenience, in line with the present tendency towards decentralization of management functions in large enterprises.

"In view of these divergent attitudes, as well as of the existence of the situations just described, it would be advisable for States, when concluding bilateral conventions, to make clear the interpretation they give to the first sentence of paragraph 4. They can, if they so desire, explain their position, or change it as compared with their previous practice, in a protocol or any other document annexed to the convention.

"A solution could also be provided in such a document to meet the objection mentioned above that the extension of the treatment of holdings in a State (A) to permanent establishments of companies which are residents of another State (B) results in such companies unduly enjoying privileged treatment as compared with other companies which are residents of the same State and whose head offices own holdings in the capital of companies which are residents of State A, in that whereas the dividends on their holdings can be repatriated by the former companies without bearing withholding tax, such tax is levied on dividends distributed to the latter companies at the rate of 5 or 15 per cent as the case may be. Tax neutrality and the equality of tax burdens as between permanent establishments and subsidiary companies, as advocated by the States concerned, could be ensured by adapting, in the bilateral convention between States A and B, the provisions of paragraphs 2 and 4 or Article 10, so as to enable withholding tax to be levied in State A on dividends paid by companies which are residents of that State to permanent establishments of companies which are residents of State B in the [p. 217] same way as if they are received directly, i.e. by the head offices of the latter companies, viz., at the rate of:

"— 5 per cent in the case of a holding of at least 25 per cent;

"— 15 per cent in all other cases.

"Should it not be possible, because of the absence of appropriate provisions in the domestic laws of the State concerned, to levy a withholding tax there on dividends paid to permanent establishments, the treatment of inter-company dividends could be extended to permanent establishments, as long as its application is limited in such manner that the tax levied by the State of source of the dividends is the same whether the dividends are received by a permanent establishment of a company which is a resident of the other State or are received directly by such a company.

"*C. Structure and rate of tax*

"In countries where enterprises, mainly companies, are charged a tax on their profits which is specific to them, the provisions of paragraph 4 raise, with regard to the rate applicable in the case of permanent establishments, especially difficult and delicate problems, which here too arise from the fact that

the permanent establishment is only a part of legal entity which is not under the jurisdiction of the State where the permanent establishment is situated.

"When the taxation of profits made by companies which are residents of a given State is calculated according to a progressive scale of rates, such a scale should, in principle, be applied to permanent establishments situated in that State. If in applying the progressive scale, the permanent establishment's State takes into account the profits of the whole company to which such a permanent establishment belongs, such a rule would not appear to conflict with the equal treatment rule, since resident companies are in fact treated in the same way. States that tax their own companies in this way could therefore define in their bilateral conventions the treatment applicable to permanent establishments.

"When a system of taxation based on a progressive scale of rates includes a rule that a minimum rate is applicable to permanent establishments, it cannot be claimed a priori that such a rule is incompatible with the equal treatment principle. The profits of the whole enterprise to which the permanent establishment belongs should be taken into account in determining the rate applicable according to the progressive scale. The provisions of the first sentence of paragraph 4 are not observed only if the minimum rate is higher.

[p. 218] "However, even if the profits of the whole enterprise to which the permanent establishment belongs is taken into account when applying either a progressive scale of rates or a minimum rate, this should not conflict with the principle of the distinct and separate enterprise, according to which the profits of the permanent establishment must be determined under paragraph 2 of article 7. The minimum amount of the tax levied in the State where the permanent establishment is situated is, therefore, the amount which would be due if it were a distinct and separate enterprise, without reference to the profits of the whole enterprise to which it belongs. The State where the permanent establishment is situated is, therefore, justified in applying the progressive scale applicable to resident enterprises solely to the profits of the permanent establishment,

leaving aside the profits of the whole enterprise when the latter are less than those of the permanent establishment. This State may likewise tax the profits of the permanent establishment at a minimum rate, provided that the same rate applies also to resident enterprises, even if taking into account the profits of the whole enterprise to which it belongs would result in a lower amount of tax, or no tax at all.

"As regards the split-rate system of company tax, it should first be pointed out as being a fact central to the issue here that most OECD Member countries which have adopted this system do not consider themselves bound by the provisions of paragraph 4 to extend it to permanent establishments of non-resident companies. This attitude is based, in particular, on the view that the split rate is only one element amongst others (in particular a withholding tax on distributed income) in a system of taxing company profits and dividends which must be considered as a whole and is therefore, both for legal and technical reasons, of domestic application only. The State where the permanent establishment is situated could claim the right not to tax such profits at the reduced rate, as generally, it does not tax the dividends distributed by the company to which the permanent establishment belongs. Moreover, a State which has adopted a split-rate system usually has other economic policy objectives, such as the promotion of the capital market, by encouraging resident companies to distribute dividends. The extension of the reduced rate to the profits of the permanent establishment would not serve such a purpose at all, as the company distributing the dividends is not a resident of the State concerned.

"This view is, however, disputed. The States in favour of extending the split-rate system to permanent establishments urge that as the essential feature of this system is a special technique of taxing profits which enterprises in a corporate form derive [p. 219] from their activities, and is designed to afford immediate relief from the double taxation levied on the profits distributed, it should be applied to permanent establishments in bilateral conventions against double taxation. It is generally recognised that, by the effects of their provisions,

such conventions necessarily result in some integration of the taxation systems of the Contracting States. On this account, it is perfectly conceivable that profits made in a State (A) by a permanent establishment of a company resident in another State (B) should be taxed in State A according to the split-rate system.

As a practical rule, the tax could in such case be calculated at the reduced rate (applicable to distributed profits) on that proportion of an establishment's profits which corresponds to the ratio between the profit distributed by the company to which it belongs and the latter's total profit; the remaining profit could be taxed at the higher rate. Of course, the two Contracting States would have to consult together and exchange all information necessary for giving practical effect to this solution. Similar considerations apply to systems where distributions of profits made can be deducted from the taxable income of a company.

"As regards the imputation system ('avoir fiscal' or 'tax credit'), it seems doubtful, at least on a literal interpretation of the provisions of paragraph 4, whether it should be extended to non-resident companies in respect of dividends paid out of profits made by their permanent establishment. In fact, it has identical effects to those of the split-rate system but these effects are not immediate as they occur only at the time of the shareholder's personal taxation. From a purely economic and financial standpoint, however, it is conceivable that such profits should be treated as though they were profits of a district company in State A where the permanent establishment of a company which is a resident of State B is situated, and, to the extent that they are distributed, carry the 'avoir fiscal' or 'tax credit'. But to take the matter further, to avoid all discrimination it is necessary that this advantage should already have been accorded to shareholders who are residents of State B of companies which are residents of State A. From the practical standpoint, the two States concerned should, of course, agree upon the conditions and procedures for allowing the 'avoir fiscal' or 'tax credit' to shareholders who are themselves re-

sidents of either State, of the companies concerned that are residents of State B.

"Contracting States which are faced with the problems described above may settle them in bilateral negotiations in the light of their peculiar circumstances.

[p. 220] *"D. Withholding tax on dividends, interest and royalties received by a permanent establishment*

"When permanent establishments receive dividends, interest or royalties such income, by virtue of paragraph 4 of Articles 10 and 11 and paragraph 3 of Article 12, respectively, comes under the provisions of Article 7 and consequently — subject to the observations made . . . as regards dividends received on holdings of permanent establishment — falls to be included in the taxable profits of such permanent establishments.

"According to the respective Commentaries on the above-mentioned provisions of Articles 10, 11 and 12 these provisions dispense the State of source of the dividends, interest or royalties received by the permanent establishment from applying any limitation provided for in those Articles, which means — and this is the generally accepted interpretation — that they leave completely unaffected the right of the State of source, where the permanent establishment is situated, to apply its withholding tax at the full rate.

"While this approach does not create any problems with regard to the provisions of paragraph 4 of article 24 in the case of countries where a withholding tax is levied on all such income, whether the latter be paid to residents (permanent establishments, like resident enterprises, being allowed to set such withholding tax off against the tax on profits due by virtue of Article 7) or to non-residents (subject to the limitations provided for in Articles 10, 11 and 12), the position is different when withholding tax is applied exclusively to income paid to non-residents.

"In this latter case, in fact, it seems difficult to reconcile the levy of withholding tax with the principle set out in paragraph 4

that for the purpose of taxing the income which is derived from their activity or which is normally connected with it — as is recognized to be the case with dividends, interest and royalties referred to in paragraph 4 of Articles 10 and 11 and in paragraph 3 of Article 12 — permanent establishments must be treated as resident enterprises and hence in respect of such income be subjected to tax on profits solely.

"In any case, it is for Contracting States which have this difficulty to settle it in bilateral negotiations in the light of their peculiar circumstances.

"E. Credit for foreign tax

"In a related context, when a permanent establishment receives foreign income which is included in its taxable profits, it is right by virtue of the same principle to grant to the permanent [p. 221] establishment credit for foreign tax borne by such income when such credit is granted to resident enterprises under domestic laws.

"If in a Contracting State (A) in which is situated a permanent establishment of an enterprise of the other Contracting State (B) credit for tax levied in a third State (C) can be allowed only by virtue of a convention, then the more general question arises, as to the extension to permanent establishments of the benefit of conventions concluded with third States . . . .

"It should, however, be pointed out that difficulties may arise as to the amount of the credit to be allowed, if permanent establishments in State A benefit from the convention which State B has concluded with State C. Such amount may be either the amount of tax effectively collected by State C or the amount of tax which State C may collect by virtue either of its convention with State A or its convention with State B. Moreover, the question arises whether such credit is not given twice, i.e. once in State A, where the permanent establishment is situated, and again in State B, the State of residence. It is for Contracting States to settle such problems, if necessary, in their bilateral negotiations.

"F. Extension to permanent establishments of the benefit of double taxation conventions concluded with third states

"While an enterprise of a State (A) can normally claim, in respect of the permanent establishment which it possesses in another State (B), the benefit of the provisions of the convention between those two States A and B, it nevertheless cannot, should such permanent establishment derive income from a third State (C), invoke the provisions of the convention between States B and C for the benefit of such permanent establishment since it, the enterprise, is in fact resident of neither of those two States . . . This is the consequence of the well-known principle of the relative effect of treaties, which means that they have effect only as between the Contracting States.

"Nor could such an enterprise invoke for this purpose a most-favoured-nation clause, however general its terms, included in a treaty or agreement concluded between States A and B. In fact, it has always been accepted that such a clause did not apply in the case of double taxation conventions because these are essentially based on the principle of reciprocity. It should, however, be noted that some States have made provision in their double taxation conventions enabling the provisions of the latter to be applied 'in special cases', to permanent establishments of enterprises of a third State."

[p. 222] *Paragraph 5*

Since this paragraph reproduces article 24, paragraph 5, of the OECD Model Convention, the commentary on that paragraph is fully relevant:

"This paragraph is designed to end a particular form of discrimination resulting from the fact that in certain countries the deduction of interest, royalties and other disbursements allowed without restriction when the recipient is resident, is restricted or even prohibited when he is a non-resident. The same situation may also be found in the sphere of capital taxation, as regards debts contracted to a non-resident. It is however open to Contracting States to modify this provision in

bilateral conventions to avoid its use for tax avoidance purposes."

In the course of the discussion by the Group of Experts of paragraph 5 a question was raised whether such a paragraph was suitable for inclusion in a tax treaty between developed and developing countries. It was suggested that the paragraph would not be acceptable to those countries that made deductibility of disbursements made abroad by foreign-owned corporations conditional on the recipient being taxed in such countries. After substantial discussion, the feeling of the Group was that the special circumstances mentioned above ought not to be the basis for treaty articles of broad application but that in cases where they were likely to create a problem they should be raised in bilateral negotiations.

Paragraph 6

Since this paragraph reproduces article 24, paragraph 6, of the OECD Model Convention, the commentary on that paragraph is fully relevant:

> "This paragraph forbids a Contracting State to give less favourable treatment to an enterprise, the capital of which is owned or controlled, wholly or partly, directly or indirectly, by one or more residents of the other Contracting State. This provision, and the discrimination which it puts an end to, relates to the taxation only of enterprises and not of the persons owning or controlling their capital. Its object therefore is to ensure equal treatment for taxpayers residing in the same State, and not to subject foreign capital, in the hands of the partners or shareholders, to identical treatment to that applied to domestic capital."

In the course of the Group's discussion of paragraph 6, some members from developing countries proposed that special measures applicable to foreign-owned enterprises should not be construed as constituting prohibited discrimination as long as all foreign-owned enterprises were treated alike; they said that that change represented [p. 223] a notable departure from the general principle of taxing foreign persons on the same basis as nationals

but that the problems of tax compliance in cases in which foreign ownership was involved and the politically sensitive position of foreign-owned enterprises in developing countries warranted the change. Therefore, they proposed that article 24, paragraph 6, of the OECD Model Convention be amended to read as follows:

> "6. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which are subjected other similar enterprises *the capital of which is wholly or partly owned or controlled, directly or indirectly, by residents of third countries*."

They went on to point out that the proposed change in paragraph 6 had been included in several tax treaties to which developed countries were parties. Some members from developed countries pointed out that such a proposal would in fact limit the effect of the non-discrimination article to the prevention of discrimination between enterprises owned by non-residents, thus leaving the door open to discrimination against enterprises owned by non-residents as a class.

Several members from developed countries expressed reservations concerning the proposed change and pointed out that they considered the OECD non-discrimination article as the backbone of the Convention. They recalled that the antecedents of the non-discrimination article in the present OECD Model Convention dated from the nineteenth century. They felt that if such a fundamental principle were to be altered, it would have a significant effect on international tax relations generally. Further, since the proposed change was motivated in part by problems with tax compliance where foreign ownership was involved — essentially, problems with transfer pricing — it was suggested that the problem might be dealt with more properly in other parts of the tax convention, such as in article 9 dealing with associated enterprises.

Some members from developing countries indicated that, while recognizing the essential importance of and need for the article on non-discrimination, some countries might wish to modify certain paragraphs of that article in bilateral negotiations. It was suggested for example that, because of the difficulties involved in determining what constituted reasonable amounts in the case of transfer payments on account of royalties, technical assistance fees, head office expenses and so on, a country might desire to deny deductions for such payments or compute the amount of deduction in accordance with the domestic law of the country when such payments were made by an [p. 224] enterprise situated within its territory to a foreign controlling company, whether the latter was resident in another Contracting State or in a third country. Another example cited was that of a country which granted tax preferences with a view to the attainment of certain national objectives which might wish to make a given percentage of local ownership of the enterprise involved a condition for the granting of such tax preferences. The Group recognized that special situations such as those mentioned as examples should be resolved in bilateral negotiations.

Paragraph 7

Since this paragraph reproduces article 24, paragraph 7, of the OECD Model Convention, the commentary on that paragraph is fully relevant:

"This paragraph states that the scope of the article is not restricted by the provisions of article 2. The article therefore applies to taxes of every kind and description levied by, or on behalf of, the State, its political subdivisions or local authorities."

C. Observations on the OECD Commentary and Reservations on Article 26 of the OECD Model Convention

Observations on the commentary

"The interpretation given in paragraphs 40 and 41 above is not endorsed by *Germany*, the tax laws of which require the application of a minimum rate with respect to non-residents. Under German tax laws, the profits of a permanent establishment of an enterprise operated in Germany by a non-resident individual are charged income tax at a minimum rate of 25 per cent. On the other hand, the German tax laws restrict the application of higher rates by strictly limiting the basis of determining the rate applicable to profits derived from German sources — thus excluding any profits derived by those parts of the enterprise which are situated abroad. Moreover, since the minimum rate of 25 per cent is close to the lower end of the progressive tax scale, which ranges from 22 per cent to 56 per cent, Germany is of the opinion that the application of the minimum rate of 25 per cent does not violate the provisions of paragraph 4.

"The *United States* observes that its non-resident citizens are not in the same circumstances as other non-residents, since the United States taxes its non-resident citizens on their worldwide income.

[p. 225] *Reservations on the article*

"*Australia, Canada* and *New Zealand* reserve their positions on this Article.

"*Paragraph* 1

"*France* accepts the provisions of paragraph 1 but wishes to reserve the possibility of granting only to French nationals the exemption, provided for in its domestic laws, of gains from the alienation of immovable property which constitutes, whether in whole or in part, the residence in France of French nationals who are domiciled abroad.

"The *United Kingdom* reserves its position on the second sentence of paragraph 1.

"*Paragraph* 4

"*Belgium* reserves the right to apply the provisions of its internal law for the purpose of taxing the profits of Belgian permanent establishments of companies and associations resident in countries with which it undertakes negotiations, when-

ever such an attitude is warranted by the general treatment accorded in such countries to permanent establishments of companies and associations resident in Belgium (paragraph 4).

"*Japan* reserves the right not to extend to the permanent establishments of non-residents the benefit of tax incentive measures introduced for national policy objectives.

"*Paragraph* 5

"*France* accepts the provisions of paragraph 5 but wishes to reserve the possibility of applying the provisions in its domestic laws relative to the limitation to the deduction of interest paid by a French company to a foreign parent company."

EXHIBIT 55

Senate Bill No. 85

CHAPTER 660

An act to add Chapter 1.9 (commencing with Section 15365), Chapter 6 (commencing with Section 15397), and Chapter 7 (commencing with Section 15398) to Part 6.7 of Division 3 of, and to add Article 12 (commencing with Section 16429.30) to Chapter 2 of Part 2 of Division 4 of, Title 2 of, the Government Code, to amend Sections 24274, 24344, 24348, 24667, and 24668 of, to amend and renumber Section 25110 of, to add Sections 24411 and 24670 to, and to add and repeal Article 1.5 (commencing with Section 25110) of Chapter 17 of Part II of Division 2 of, the Revenue and Taxation Code, relating to taxation.

[Approved by Governor September 5, 1986. Filed with Secretary of State September 5, 1986.]

LEGISLATIVE COUNSEL'S DIGEST

SB 85, Alquist. Bank and corporation taxes: unitary businesses.

(1) Existing law provides for the organization of corporations for specific purposes.

This bill would provide for the establishment of a nonprofit public benefit corporation to be known as the Small Business Bond Insurance Corporation. This bill would provide for the membership, compensation, duties, and powers of the corporation's board of directors.

The corporation would have the primary goal of increasing the availability of long-term financing to small businesses in California, and the primary method of accomplishing this goal would be through insurance or guarantees of the payment of bonds issued by or for the benefit of small businesses.

This bill would establish a California Small Business Bond Insurance Corporation Operations Fund in the State Treasury for the receipt of state, federal, and private moneys for the operating expenses of the corporation and would provide, upon appropriation by the Legislature, for the manner in which the moneys in the fund are to be disbursed.

This bill would establish a California Small Business Bond Insurance Reserve Fund in the State Treasury for the receipt of state, federal, and private moneys, returns on investments on these moneys, premiums charged by the corporation, and recoveries and collection on claims paid by the corporation. This bill would provide that the moneys in the fund are to be made available, upon appropriation by the Legislature, for purposes of the small business bond insurance programs conducted by the corporation.

(2) Existing law charges the California State World Trade Commission with encouraging international trade, tourism, and development.

This bill would create within the commission a California Office of Trade Policy to, among other things, support vigorous enforcement of trade laws against unfair foreign trade practices in United States markets.

This bill would also create within the commission the California Office of Export Promotion to, among other things, strengthen the state's activities in marketing its agricultural, manufacturing, and service industries overseas.

(3) Existing law creates various departments within the Business, Transportation and Housing Agency.

This bill would create within the agency a Development Review Panel, consisting of specified membership, to promote and assist economic development projects where additional development or expansion otherwise is not possible because of a lack of adequate funding for infrastructure. It would specify the powers and duties of this panel. It would provide that all moneys loaned to the panel that are required to be repaid shall be deposited in a specified fund.

(4) This bill would create in the State Treasury a California Unitary Fund, the moneys of which would be used exclusively for infrastructure financing and economic development. It would create the Future Infrastructure State Targeted Account and the Local Project Account for Non-Transient Spending in the California Unitary Fund. It would require the moneys in the California Unitary Fund to remain in the fund until appropriated by the Legislature and upon appropriation would require that moneys in the Future Infrastructure State Targeted Account be made available in specified percentages for specified purposes.

(5) Under the existing Bank and Corporation Tax Law, the income of a unitary business which is subject to taxation is determined by means of an apportionment formula based on income derived from or attributable to sources both within and without the state. That formula generally includes the use of 3 factors: payroll, property, and sales.

This bill would allow a qualified taxpayer, as defined, whose income is subject to the tax imposed under the Bank and Corporation Tax Law to determine its income derived from or attributable to sources within this state pursuant to a water's-edge election, as specified. This bill would require that a water's-edge election be made by contract with the Franchise Tax Board, as specified, for an initial term of 10 years and subject to annual renewal. It would provide for the method of terminating the election by written notice of nonrenewal by the taxpayer.

This bill would require that each contract provide for annual payments to be made by the taxpayer to the Franchise Tax Board for deposit in the California Unitary Fund, which this bill would create. This bill would require that of the amount of annual payments made by qualified taxpayers for deposit in the California Unitary Fund, ⅓ of that amount be deposited in the Local Project Account for Non-Transient Spending and ⅔ of that amount be deposited in the Future Infrastructure State Targeted Account.

This bill would also provide for various new administrative procedures in connection with the water's-edge election and would require the Franchise Tax Board to conduct a specified

study relating to certain auditing practices to be reported to the Legislature no later than March 1, 1987.

(6) Under the existing Bank and Corporation Tax Law, a taxpayer is generally entitled to deduct dividends received in computing its income subject to tax if the dividends were declared from income which has been included in the measure of taxes imposed under that law upon the taxpayer declaring the dividends. In the case of a unitary business, dividends received which are treated as nonbusiness income are entirely allocable to this state in computing the taxpayer's income if its commercial domicile is in this state, and dividends received which are treated as business income are subject to allocation and apportionment to this state under the unitary apportionment formula in computing the taxpayer's income.

This bill would permit a qualified taxpayer who elects to determine its income under a water's-edge election to deduct either 100% or 75% of specified portions of its qualifying dividends, as defined, which are received in accordance with specified formulas.

(7) Under the existing Bank and Corporation Tax Law, a taxpayer may take a deduction for debts which become wholly or partially worthless within the income year or for a reasonable addition to a reserve for bad debts. The amount of the deduction may be determined using either the specific charge-off method or the reserve method.

This bill would eliminate the availability of the reserve method of deducting bad debts for all taxpayers, other than savings and loan associations, banks, or financial corporations. It would also provide special transitional rules in connection with these changes.

Under the existing Bank and Corporation Tax Law, a dealer in real and tangible personal property who is liable as an endorser, guarantor, or indemnitor may deduct a reasonable addition to a reserve for bad debts from losses on the guaranteed debts.

This bill would eliminate the availability of the reserve method of deducting those debts for those dealers. It would also provide special transitional rules in connection with these changes.

(8) Under the existing Bank and Corporation Tax Law, gain from certain sales of property in exchange for which the seller receives deferred payments is reported on the installment method, unless the taxpayer elects otherwise.

This bill would limit the availability of the installment method of accounting in specified circumstances, including sales involving certain publicly traded property, sales pursuant to a revolving credit plan, and a portion of certain installment receivables, based on the amount of the outstanding indebtedness of the taxpayer. It would provide special transitional rules for some of these changes.

(9) This bill would become operative on January 1, 1988, and its tax provisions would be applicable in the computation of taxes for income years commencing on or after January 1, 1988.

The people of the State of California do enact as follows:

SECTION 1. Chapter 1.9 (commencing with Section 15365) is added to Part 6.7 of Division 3 of Title 2 of the Government Code, to read:

Chapter 1.9. California Export Promotion and Policy Program

Article 1. Trade Policy

15365. There is within the California State World Trade Commission a California Office of Trade Policy.

15365.2. The purposes of the California Office of Trade Policy are the following:

(a) To support vigorous enforcement of trade laws against unfair foreign trade practices in United States markets, in the markets of offending countries, and in third-country markets.

(b) To encourage international negotiations to reduce and eliminate restrictive trade practices abroad, including quotas,

tariffs, subsidies, nontariff barriers, and commercial counterfeiting.

(c) To participate in the development of international agreements which affect California's economic interests in cooperation with the Office of the United States Trade Representative.

(d) To respond to industry complaints concerning foreign trade barriers, and help represent their interests before appropriate agencies.

Article 2. Export Promotion

15365.6 There is within the California State World Trade Commission a California Office of Export Promotion.

15365.8 The purpose of the California Office of Export Promotion is to strengthen the state's activities in marketing its agricultural, manufacturing, and service industries overseas. The office shall be responsible for conducting market research; disseminating trade leads; sponsoring trade delegations, missions, marts, seminars, and other appropriate promotional events, and for establishing overseas offices in foreign countries, if appropriate and economically feasible. The office shall consult with the Department of Food and Agriculture on the promotion of agricultural commodities overseas.

SEC. 2. Chapter 6 (commencing with Section 15397) is added to Part 6.7 of Division 3 of Title 2 of the Government Code, to read:

CHAPTER 6. CALIFORNIA DEVELOPMENT REVIEW PANEL

Article 1. Membership

15397. (a) There is within the Business, Transportation and Housing Agency a Development Review Panel consisting of five members as follows:

(1) The Secretary of the Business, Transportation and Housing Agency, who shall serve as chairperson.

(2) The Secretary of the Resources Agency.

(3) The Secretary for Environmental Affairs.

(4) One Member of the Senate, appointed by the Senate Rules Committee.

(5) One Member of the Assembly, appointed by the Speaker of the Assembly.

(b) The Members of the Senate and Assembly shall meet with and, except as otherwise provided by the Constitution, advise the panel to the extent that this participation is not incompatible with their respective positions as Members of the Legislature.

(c) All necessary staffing to carry out the panel's duties and responsibilities shall be provided by the Department of Commerce.

Article 2. Purpose and Powers

15397.3 The purpose of the Development Review Panel shall be to promote and assist economic development projects in the state where additional development or expansion is otherwise not possible due to lack of adequate funding for infrastructure.

15397.5 It is the intent of the Legislature that funds appropriated for the purpose of the Development Review Panel not be used in lieu of or as supplemental funds to any existing state infrastructure financing program, including, but not limited to, the State Transportation Improvement Program or the Clean Water Bond Program.

15397.7. The panel shall meet regularly to review projects submitted to it for funding assistance. To facilitate its activities, the panel shall have the power to do all of the following:

(a) Adopt bylaws for the regulation of its affairs and the conduct of its business, and prepare and promulgate rules and regulations.

(b) Contract for legal, financial, and other services as well as services of appropriate state agencies as may, in its judgment, be necessary for it to evaluate an application for financial assistance.

(c) Make secured loans to any local agency in connection with the financing of public capital improvements projects in accordance with a loan agreement between the authority and the local agency.

(d) Assign or pledge all or any portion of its interests in mortgages, deeds of trust, indentures of mortgage or trust, or similar instruments, notes, and security interests in property, tangible or intangible, of a local agency to which the authority has made loans, and the revenues therefrom, including payment or income from any interest owed or held by the authority for the benefit of the holders of bonds issued to finance public capital improvements.

(e) Enter into any agreement or contract, execute any instrument, and perform any act or thing necessary, convenient, or desirable to carry out any power expressly given to the panel.

(f) Invest any moneys held in reserve or any moneys not required for immediate use or disbursement in obligations that are authorized by law for the investment of trust funds in the custody of the Treasurer.

(g) Request assistance and information from any department, division, board, commission, or other agency of the state as the panel may need to carry out its duties.

(h) Set such other terms and conditions by resolution pursuant to this section as it deems to be necessary, appropriate, and in the public interest in furtherance of the purposes of this chapter.

Article 3. Duties

15397.9 The panel shall establish criteria for the selection of projects to receive financing assistance. Criteria established by the panel shall include, but not be limited to, the following:

(a) The project must be demonstrated to be infeasible without the assistance of the panel.

(b) The project is needed to attract or otherwise accommodate the location or expansion of a specific industrial enterprise with high employment potential.

(c) A demonstration of community need for economic development.

(d) A demonstration of financial need for state assistance.

(e) Evidence of firm financial commitment on the part of the business or enterprise associated with the project.

(f) The cost per job created or retained is greater than or equal to a threshold established by the panel as part of its evaluation criteria.

(g) Evidence of site control, including any leases, easements, covenants, or encumbrances which may affect the project.

(h) Demonstration of ability to administer the project and state assistance requirements.

(i) Consistency with a city, county, or city and county general plan.

(j) Compliance with the California Environmental Quality Act as set forth in Division 13 (commencing with Section 21000) of the Public Resources Code.

15397.11. (a) Not less than 30 percent of the funds appropriated to the panel in any given fiscal year shall be set aside for projects submitted by rural cities and counties.

(b) For the purposes of this section, "rural city" means a city of less than 50,000 population located in a county of less than 600,000 population.

(c) For the purposes of this section, "rural county" means any unincorporated portion of a county of less than 200,000 population located within a county with a population of less than 600,000.

15397.13. Any city or county, or any city or county acting on behalf of a special district or local agency, may submit an application for financing assistance pursuant to this chapter which includes all of the following:

(a) A resolution in support of the public capital improvement and the financial assistance requested that has been adopted by the legislative body of the local agency.

(b) Financial, legal, and other information which is required by the panel to make a determination of significant public benefits.

(c) An estimate of the maximum amount and type of assistance to be requested.

(d) A description of the public capital improvement or project.

(e) A financing plan for the public capital improvement, including the amount of debt, if any, and the maximum term of maturity of any bond issue, and the identification of revenue sources that will be dedicated to the payment of the principal and interest on the bonds.

(f) A description of the public capital improvement's economic feasibility.

(g) The number of any type of permanent jobs to be either created or retained by the project.

15397.15. Applications for projects not in accordance with the reasonable priorities and criteria that the panel has established need not be accepted or further processed by the panel.

15397.17. The panel shall make a determination on the application within 30 days of receipt of the application, excepting that time required to correct deficiencies in the application.

15397.19. (a) The panel shall contract with local jurisdictions submitting projects accepted by the panel for financing assistance. For the purposes of this section, the panel shall be authorized to provide all of the following types of assistance:

(1) Interest rate assistance on local bonds.

(2) Grants-in-aid for projects.

(3) Secured loans.

(4) Matching funds to increase eligibility for other funds.

(b) Not more than 50 percent of the funds committed by the panel in any given fiscal year may be for direct grants.

(c) Not more than two million dollars ($2,000,000) may be spent on any one project.

(d) Grants will only be made when other funding options are financially infeasible.

(e) Contracts will be executed within one week of approval of projects. Funds will be transferred within 30 days of execution of the contract.

(f) A report certifying completion of the project will be required of the recipient as will a closeout report certifying number of permanent employment opportunities created by the project.

15397.21. Neither the completion of the project nor the operation of the facility will have the proximate effect of relocation of any substantial operations of the company from one area of the state to another or in the abandonment of any substantial operations of the company within other areas of the state, or, if the completion or operation will have either of the effects, then completion or operation is reasonably necessary to prevent the relocation of any substantial operations of the company from an area within the state to an area outside the state.

15397.23. All moneys loaned or otherwise made available by the panel and that are required to be repaid shall be deposited in the California Unitary Fund (Article 12 (commencing with Section 16429.30) of Chapter 2 of Part 2 of Division 4) and entirely made available for the expenditure for the purposes and uses of the panel, upon appropriation by the Legislature.

SEC. 3. Chapter 5 (commencing with Section 15398) is added to Part 6.7 of Division of Title 2 of the Government Code. to read:

Chapter 7. Small Business Bond Insurance Corporation

15398. There is in state government a nonprofit public benefit corporation which shall be known as the Small Business Bond Insurance Corporation.

15398.1. The primary goal of the corporation is to increase the availability of long-term financing to small businesses in California. The primary method for accomplishing this goal shall be

through the provision of insurance or guarantees of the payment of bonds issued by or for the benefit of small businesses which utilize bond financing as a source of long-term capital, including bonds issued pursuant to the California Industrial Development Financing Act (Title 10 (commencing with Section 91500)). Other methods of achieving the primary goal, including bond pooling, may be adopted by the corporation.

15398.2. The corporation shall be a nonprofit public benefit corporation and shall be subject to the Nonprofit Public Benefit Corporation Law (Part 2 (commencing with Section 5110) of Division 2 of Title 1 of the Corporations Code), except as specifically provided in this chapter.

15398.3. (a) The corporation shall be governed by a board of directors consisting of seven members as follows:

(1) The Secretary of the Business, Transportation and Housing Agency or his or her designee.

(2) The Treasurer or his or her designee.

(3) The Executive Director of the Office of Small Business or his or her designee.

(4) Two members to be appointed by the Governor as follows:

(A) One member with a minimum of three years' experience as an officer or employee of a financial institution.

(B) One member with a minimum of three years' experience as an owner or employee of a small business.

(5) One member to be appointed by the Senate Rules Committee.

(6) One member to be appointed by the Speaker of the Assembly.

(b) The terms of the Governor's initial appointees shall be two years. The terms of subsequent appointees by the Governor and all appointees by the Senate Rules Committee and the Speaker of the Assembly shall be three years. The terms shall expire on December 31. All appointees shall serve at the pleasure of the

appointing authority and vacancies shall be filled by the appointing authority.

(c) Initial appointments to the board shall be made within 90 days of the operative date of this chapter.

15398.4. The board shall do all of the following:

(a) Elect a chair and vice chair from among its members. The chair, if present, shall preside at meetings of the board; otherwise the vice chair shall preside.

(b) Adopt bylaws as required to govern the conduct and operation of the board.

(c) File articles of incorporation with the Secretary of State. The articles shall include a statement of purposes that conforms to the goals set forth in this chapter.

(d) Hold regularly scheduled meetings, at least quarterly, to carry out the objectives and responsibilities of the board.

(e) Hire an executive director to provide overall management for the corporation's programs.

(f) Establish the salaries of the executive director and other staff.

(g) Promulgate rules and regulations necessary to the operation of the corporation's programs in an effective and fiscally sound manner.

(h) Adopt criteria establishing eligibility requirements for its programs.

(i) Issue an annual report to the Governor and the Legislature covering the operations and impact of its programs and recommending ways in which the state can improve the financial health of small businesses.

(j) Appoint advisory groups, as it deems necessary, to carry out the powers and duties of the board.

(k) Design, establish, and implement bond insurance, coinsurance, and bond pooling programs necessary to carry out the goals of this chapter.

15398.5. The executive director shall do all of the following:

(a) Carry out management directives of the board.

(b) Manage and disburse funds and maintain records.

(c) Direct all staff and, hire and dismiss employees.

(d) Submit an annual budget, with the approval of the board, which shall be included in the Governor's proposed budget.

(e) Coordinate the activities and programs of the corporation with those of the Office of Small Business, the State Assistance Fund for Energy, the California Business and Industrial Corporation, the California Export Finance Office, and the California Industrial Development Financing Advisory Commission in order to minimize duplication of effort and improve the effectiveness of the corporation's programs.

15398.6. (a) There is in the State Treasury the California Small Business Bond Insurance Reserve Fund the purpose of which is to receive federal, state, and private moneys, any return on investments of those moneys by the Treasurer, premiums which may be charged by the corporation for insurance or coinsurance programs, and recoveries and collections on claims paid by the corporation. All moneys in the fund, upon appropriation by the Legislature, shall be allocated by the board for the corporation's small business bond insurance programs in accordance with the purposes of this chapter.

(b) Upon appropriation by the Legislature, all moneys in the fund shall be paid out by the Treasurer on warrants drawn by the Controller upon order of the board in furtherance of the purposes of this chapter, including the payment of claims under programs of the board, payments for insurance, coinsurance, and reinsurance, and payments required by state, federal, or private bond insurance programs conducted by the board.

(c) The state shall not be liable or obligated in any way beyond the state money which is allocated and deposited in the fund from state money which is appropriated for that purpose.

(d) The board may request the Treasurer to invest those moneys in the fund which are not immediately encumbered by

the corporation's administrative or program costs, in securities issued by the Treasury of the United States government or the government of the State of California. Returns from these investments shall be deposited in the fund and, upon appropriation by the Legislature, shall be used to support loan guarantees, bond insurance, and bond coinsurance as provided in this chapter.

15398.7. (a) There is in the State Treasury the California Small Business Bond Insurance Corporation Operations Fund the purpose of which is to receive state, federal, and private moneys to be used to cover the operating expenses of the corporation.

(b) Upon appropriation by the Legislature, all moneys in the fund shall be paid out by the Treasurer on warrants drawn by the Controller upon order of the board in furtherance of the purposes of this chapter.

(c) The corporation may charge fees for its guarantees, insurance, coinsurance, and other programs and these fees shall be deposited in the fund and, upon appropriation by the Legislature, shall be used to defray the operating expenses of the corporation.

15398.8. If the Legislature has appropriated funds to the California Small Business Bond Insurance Corporation Operations Fund, board members may receive reimbursement, including per diem equal to that received by state employees, for their actual and necessary expenses incurred in the performance of their duties. Board members, who are not employees of the state, may also be paid a stipend, at the discretion of the board, for each day they devote to official board business. The board shall determine the amount of the stipend; however, the stipend shall not exceed one hundred dollars ($100) for any calendar day. Board members may not receive stipends for more than 24 calendar days in any calendar year.

15398.9. (a) The Secretary of the Business, Transportation and Housing Agency or his or her designee shall act as the interim chair of the board of directors and shall continue in that capacity until a permanent chair is elected by the board. The interim chair shall, as soon after the operative date of this chapter as is practical, convene a meeting of the board.

(b) The board may request the Office of Small Business to provide staff support and other necessary assistance in establishing the corporation.

SEC. 4. Article 12 (commencing with Section 16429.30) is added to Chapter 2 of Part 2 of Division 4 of Title 2 of the Government Code, to read:

Article 12. California Unitary Fund

16429.30. There is in the State Treasury the California Unitary Fund, which is hereby created, consisting of all money deposited in the fund pursuant to any provision of law. There is also hereby created the Future Infrastructure State Targeted Account in the California Unitary Fund and the Local Project Account for Non-Transient Spending in the California Unitary Fund. All money in the fund shall be used exclusively for infrastructure financing and economic development.

16429.32. Eighty percent of the money deposited in the Future Infrastructure State Targeted Account shall be available for expenditure for the purposes and uses of the California Development Review Panel upon appropriation by the Legislature.

16429.34. Twenty percent of the money deposited in the Future Infrastructure State Targeted Account shall be available for expenditure only for the following purposes and uses upon appropriation by the Legislature:

(a) Support of the California Export Finance Program Law (Chapter 5 (commencing with Section 15390) of Part 6.7 of Division 3).

(b) Support of the California Export Promotion and Policy Program (Chapter 1.9 (commencing with Section 15365) of Part 6.7 of Division 3).

(c) Support of the California Small Business Bond Insurance Corporation (Chapter 7 (commencing with Section 15398) of Part 6.7 of Division 3).

(d) Support of the Foreign Market Development Export Incentive Program for California Agriculture Act, as established by Chapter 1189 of the Statutes of 1985.

16429.36. Any money deposited in the fund pursuant to Section 15397.23 shall not be subject to apportionment under Sections 16429.32 and 16429.34.

16429.38. All proposed appropriations from the fund shall be summarized in a section of the Governor's Budget for each fiscal year and shall bear the caption "California Unitary Infrastructure and Economic Development Program." The section shall contain a separate description of each program for which an appropriation is made. Appropriations shall be made to the department or entity administering the program and shall be accounted for separately.

16429.40. The Secretary of the Business, Transportation and Housing Agency shall be responsible for annually recommending to the Governor, for inclusion in the Budget Bill, which programs shall be supported by the California Unitary Fund.

16429.49. The moneys in the California Unitary Fund shall remain in the fund until appropriated by the Legislature and upon appropriation shall be used only for those purposes provided in this article.

SEC. 5. Section 24274 of the Revenue and Taxation Code is amended to read:

24274. There shall be included in gross income for the income year the amount of any increase in the suspense account required by subparagraph (B) of paragraph (2) of subdivision (c) of Section 24685 (relating to accrual of vacation pay).

SEC. 6. Section 24344 of the Revenue and Taxation Code is amended to read:

24344. (a) Except as limited by subdivision (b), there shall be allowed as a deduction all interest paid or accrued during the income year on indebtedness of the taxpayer.

(b) If income of the taxpayer which is derived from or attributable to sources within this state is determined pursuant to Section 25101 or 25110, the interest deductible shall be an amount equal to interest income subject to apportionment by formula, plus the amount, if any, by which the balance of interest expense exceeds interest and dividend income (except dividends

deductible under the provisions of Section 24402 and dividends subject to the deductions provided for in Section 24411 to the extent of those deductions) not subject to apportionment by formula. Interest expense not included in the preceding sentence shall be directly offset against interest and dividend income (except dividends deductible under the provisions of Section 24402 and dividends subject to the deductions provided for in Section 24411 to the extent of those deductions) not subject to apportionment by formula.

(c) Notwithstanding subdivision (b), interest expense incurred for purposes of foreign investments may be offset against dividends deductible under Section 24411.

SEC. 7. Section 24348 of the Revenue and Taxation Code is amended to read:

24348. (a) (1) There shall be allowed as a deduction either of the following:

(A) Debts which become worthless within the income year in an amount not in excess of the part charged off within that income year.

(B) In the case of a savings and loan association, bank, or financial corporation, in lieu of any deduction under subparagraph (A), in the discretion of the Franchise Tax Board, a reasonable addition to a reserve for bad debts.

(2) When satisfied that a debt is recoverable in part only the Franchise Tax Board may allow that debt, in an amount not in excess of the part charged off within the income year, as a deduction; provided, however, that if a portion of a debt is claimed and allowed as a deduction in any year no deduction shall be allowed in any subsequent year for any portion of the debt which in any prior year was charged off, regardless of whether claimed as a deduction in that prior year.

(b) (1) The amendments to this section made during 1985-86 Regular Session by the act adding this subdivision shall apply only to income years beginning after December 31, 1987.

(2) In the case of any taxpayer who maintained a reserve for bad debts for that taxpayer's last income year beginning before January 1, 1988, and who is required by the amendments to this section to change its method of accounting for any income year, all of the following shall apply:

(A) That change shall be treated as initated by the taxpayer.

(B) That change shall be treated as made with the consent of the Franchise Tax Board.

(C) The net amount of adjustments required by Article 6 (commencing with Section 24721) of Chapter 13, to be taken into account by the taxpayer shall:

(i) In the case of a taxpayer maintaining a reserve under former subdivision (b) (prior to the amendments made during the 1985-86 Regular Session by the act adding this subdivision), be reduced by the balance in the suspense account under paragraph (4) of that subdivision as of the close of such last income year; and

(ii) Be taken into account ratably in each of the first five income years beginning after December 31, 1987.

SEC. 8. Section 24411 is added to the Revenue and Taxation Code, to read:

24411. (a) For purposes of those taxpayers electing to compute income under Section 25110, 100 percent of the qualifying dividends described in subdivision (c) and 75 percent of the qualifying dividends described in subdivisions (b) and (d). "Qualifying dividends" means those received from corporations regardless of the place it is incorporated if both of the following conditions are satisfied:

(1) The average of the property, payroll, and sales factors within the United States for the corporation is less than 20 percent.

(2) More than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned by the taxpayer.

(b) Qualifying dividends equal to the greatest amount of dividends received in any one of the income years constituting the base period.

(c) The amount of fully excluded dividends, if the taxpayer's greatest foreign payroll factor for any income year in the base period exceeds the taxpayer's foreign payroll factor for the income year, which shall be determined as follows:

(1) The taxpayer's foreign payroll factor in the income year shall be subtracted from the greatest of the taxpayer's foreign payroll factor for any income year in the base period.

(2) The amount determined pursuant to paragraph (1) shall be divided by the greatest of the taxpayer's foreign payroll factor for any income year in the base period.

(3) The percentage determined in paragraph (2) shall be multiplied by the total qualifying foreign dividends. The amount so determined shall be the amount of fully excluded dividends.

(4) The amount determined in paragraph (3) shall not exceed the amount of qualifying dividends in excess of the base dividends determined in subdivision (b).

(5) If the amount of fully excluded dividends determined pursuant to paragraph (3) is less than the amount of qualified dividends in excess of the amount of base dividends determined pursuant to subdivision (b), the difference shall be added to the base dividends determined pursuant to subdivision (b).

(d) The amount of partially excluded dividends, if the taxpayer's greatest foreign payroll factor for any income year in the base period is the same as or less than the taxpayer's foreign payroll factor in the income year, which shall be determined as follows:

(1) The taxpayer's greatest foreign payroll factor for any income year in the base period shall be subtracted from the taxpayer's foreign payroll factor in the income year.

(2) The amount determined pursuant to paragraph (1) shall be divided by the taxpayer's foreign payroll factor in the income year.

(3) The percentage determined in paragraph (2) shall be multiplied by the total qualifying foreign dividends.

(4) The amount determined in paragraph (3) shall be subtracted from the amount of qualifying dividends in excess of the amount of base dividends determined in subdivision (b).

(5) The balance shall be the amount of partially excluded dividends.

(e) The base period shall consist of the income year ending before January 1, 1987, and the two immediately preceding income years.

(f) A taxpayer's foreign payroll factor for an income year shall be a fraction, the numerator of which is the total amount paid outside the United States during the income year by the taxpayer and its affiliates for compensation, and the denominator of which is the total compensation paid everywhere during the income year.

SEC. 9. Section 24667 of the Revenue and Taxation Code is amended to read:

24667. (a) Except as otherwise provided in this section, income from an installment sale shall be taken into account for purposes of this part under the installment method.

(b) For purposes of this section —

(1) The term 'installment sale" means a disposition of property where at least one payment is to be received after the close of the income year in which the disposition occurs.

(2) The term 'installment sale" does not include —

(A) A disposition of personal property on the installment plan by a person who regularly sells or otherwise disposes of personal property on the installment plan.

(B) A disposition of personal property of a kind which is required to be included in the inventory of the taxpayer if on hand at the close of the income year.

(c) For purposes of this section, the term "installment method" means a method under which the income recognized for

any income year from a disposition is that proportion of the payments received in that year which the gross profit (realized or to be realized when payment is completed) bears to the total contract price.

(d) (1) Subdivision (a) shall not apply to any disposition if the taxpayer elects to have subdivision (a) not apply to such disposition.

(2) Except as otherwise provided, an election under paragraph (1) with respect to a disposition may be made only on or before the due date prescribed by law (including extensions) for filing the taxpayer's return of the tax imposed by this part for the income year in which the disposition occurs. Such an election shall be made in the manner prescribed by the Franchise Tax Board.

(3) An election under paragraph (1) with respect to any disposition may be revoked only with the consent of the Franchise Tax Board.

(e) (1) If—

(A) Any person disposes of property to a related person (hereinafter in this subdivision referred to as the "first disposition"), and

(B) Before the person making the first disposition receives all payments with respect to such disposition, the related person disposes of the property (hereinafter in this subdivision referred to as the "second disposition"),

then, for purposes of this section, the amount realized with respect to such second disposition shall be treated as received at the time of the second disposition by the person making the first disposition.

(2) (A) Except in the case of marketable securities, paragraph (1) shall apply only if the date of the second disposition is not more than two years after the date of the first disposition.

(B) The running of the two-year period set forth in subparagraph (A) shall be suspended with respect to any property for any

period during which the related person's risk of loss with respect to the property is substantially diminished by—

(i) The holding of a put with respect to such property (or similar property),

(ii) The holding by another person of a right to acquire the property, or

(iii) A short sale or any other transaction.

(3) The amount treated for any income year as received by the person making the first disposition by reason of paragraph (1) shall not exceed the excess of—

(A) The lesser of—

(i) The total amount realized with respect to any second disposition of the property occurring before the close of the income year, or

(ii) The total contract price for the first disposition, over

(B) The sum of—

(i) The aggregate amount of payments received with respect to the first disposition before the close of such year, plus

(ii) The aggregate amount treated as received with respect to the first disposition for prior income years by reason of this subdivision.

(4) For purposes of this subdivision, if the second disposition is not a sale or exchange, an amount equal to the fair market value of the property disposed of shall be substituted for the amount realized.

(5) If paragraph (1) applies for any income year, payments received in subsequent income years by the person making the first disposition shall not be treated as the receipt of payments with respect to the first dispoisiton to the extent that the aggregate of such payments does not exceed the amount treated as received by reason of paragraph (1).

(6) For purposes of this subdivision —

(A) Any sale or exchange of stock to the issuing corporation shall not be treated as a first disposition.

(B) A compulsory or involuntary conversion (within the meaning of Section 24944) and any transfer thereafter shall not be treated as a second disposition if the first disposition occurred before the threat or imminence of the conversion.

(C) Any transfer after the earlier of —

(i) The death of the person making the first disposition, or

(ii) The death of the person acquiring the property in the first disposition, and any transfer thereafter shall not be treated as a second disposition.

(7) This subdivision shall not apply to a second disposition (and any transfer thereafter) if it is established to the satisfaction of the Franchise Tax Board that neither the first disposition nor the second disposition had as one of its principal purposes the avoidance of bank and corporation tax.

(8) The period for assessing a deficiency with respect to a first disposition (to the extent such deficiency is attributable to the application of this subdivision) shall not expire before the day which is two years after the date on which the person making the first disposition furnishes (in such manner as the Franchise Tax Board may prescribe) a notice that there was a second disposition of the property to which this subdivision may have applied. Such deficiency may be assessed notwithstanding the provisions of any law or rule of law which would otherwise prevent such assessment.

(f) For purposes of this section —

(1) Except for purposes of subdivisions (g) and (h), the term "related person" means a person whose stock would be attributed under Section 24497 (other than subdivision (d) thereof) to the person first disposing of the property.

(2) The term "marketable securities" means any security for which, as of the date of the disposition, there was a market on an established securities market or otherwise.

(3) Except as provided in paragraph (4), the term "payment" does not include the receipt of evidences of indebtedness of the person acquiring the property (whether or not payment of such indebtedness is guaranteed by another person).

(4) Receipt of a bond or other evidence of indebtedness which —

(A) Is payable on demand, or

(B) Is issued by a corporation or a government or political subdivision thereof and is readily tradable, shall be treated as receipt of payment.

(5) For purposes of paragraph (4), the term "readily tradable" means a bond or other evidence of indebtedness which is issued —

(A) With interest coupons attached or in registered form (other than one in registered form which the taxpayer establishes will not be readily tradable in an established securities market), or

(B) In any other form designed to render such bond or other evidence of indebtedness readily tradable in an established securities market.

(6) In the case of any exchange described in subdivision (b) of Section 24941 —

(A) The total contract price shall be reduced to take into account the amount of any property permitted to be received in such exchange without recognition of gain,

(B) The gross profit from such exchange shall be reduced to take into account any amount not recognized by reason of subdivision (b) of Section 24941, and

(C) The term "payment," when used in any provision of this section other than paragraph (1) of subdivision (b), shall not include any property permitted to be received in such exchange without recognition of gain.

Similar rules shall apply in the case of an exchange which is described in Section 24535 and is not treated as a dividend.

(7) The term "depreciable property" means property of a character which (in the hands of the transferee) is subject to the allowance for depreciation provided in Section 24349.

(g) (1) In the case of an installment sale of depreciable property between related persons within the meaning of subdivision (b) of Section 1239 of the Internal Revenue Code, subdivision (a) shall not apply, and, for purposes of this part, all payments to be received shall be deemed received in the year of the disposition.

(2) Paragraph (1) shall not apply if it is established to the satisfaction of the Franchise Tax Board that the disposition did not have as one of its principal purposes the avoidance of bank and corporation tax.

(h) (1) (A) If, in connection with a liquidation to which Section 24512 applies, in a transaction to which Section 24501 applies the shareholder receives (in exchange for the shareholder's stock) an installment obligation acquired in respect of a sale or exchange by the corporation during the 12-month period set forth in subdivision (b) of Section 24512, then, for purposes of this section, the receipt of payments under such obligation (but not the receipt of such obligation) by the shareholder shall be treated as the receipt of payment for the stock.

(B) Subparagraph (A) shall not apply to an installment obligation described in paragraph (2) of subdivision (a) of Section 24513 unless such obligation is also described in paragraph (2) of subdivision (b) of Section 24513.

(C) If the obligor of any installment obligation and the shareholder are married to each other or are related persons (within the meaning of subdivision (b) of Section 1239 of the Internal Revenue Code), to the extent such installment obligation is attributable to the disposition by the corporation of depreciable property —

(i) Subparagraph (A) shall not apply to such obligation, and

(ii) For purposes of this part, all payments to be received by the shareholder shall be deemed received in the year the shareholder receives the obligation.

(D) For purposes of subparagraph (A) of paragraph (1) of subdivision (e), disposition of property by the corporation shall be treated also as disposition of such property by the shareholder.

(E) For purposes of subparagraph (A), in any case to which subdivision (c) of Section 24514 applies, an obligation acquired in respect of a sale or exchange by the selling corporation shall be treated as so acquired by the corporation distributing the obligation to the shareholder.

(2) If —

(A) Paragraph (1) applies with respect to any installment obligation received by a shareholder from a corporation, and

(B) By reason of the liquidation such shareholder receives property in more than one income year, then, on completion of the liquidation, basis previously allocated to property so received shall be reallocated for all such income years so that the shareholder's basis in the stock of the corporation is properly allocated among all property received by such shareholder in such liquidation.

(i) (1) In the case of any installment sale of property to which subdivision (a) applies, both of the following shall apply:

(A) Notwithstanding any other provision of this part, any recapture income shall be recognized in the year of the disposition.

(B) Any gain in excess of the recapture income shall be taken into account under the installment method.

(2) For purposes of paragraph (1), "recapture income" means, with respect to any installment sale, the amount by which the lower of —

(A) The recomputed basis of the property, or

(B) (i) In the case of a sale, exchange, or involuntary conversion, the amount realized, or

(ii) In the case of any other disposition, the fair market value of the property, exceeds the adjusted basis of the property.

(3) This subdivision shall not apply to any intallment sale of property which is irrigation equipment which is used to irrigate farmland.

(4) For purposes of this subdivision, "recomputed basis" means the adjusted basis of the property recomputed by adding thereto both of the following:

(A) All depreciation adjustments attributable to periods after December 31, 1962.

(B) Any amount deducted under Section 24356.3 (relating to expensing of certain business assets).

(j) (1) This section shall not apply to any installment obligation arising out of a sale of either of the following:

(A) Stock or securities which are traded on an established securities market.

(B) To the extent provided in regulations, property (other than stock or securities) of a kind regularly traded on an established market under regulations.

(2) This subdivision shall not apply to any sale of crops or livestock held for slaughter.

(3) The Franchise Tax Board may disallow the use of the installment method in whole or in part for transactions in which the rules of this subdivision otherwise would be avoided through the use of related parties or other intermediaries.

(k) (1) The Franchise Tax Board may prescribe such regulations as may be necessary or appropriate to carry out the provisions of this section.

(2) The regulations prescribed under paragraph (1) shall include regulations providing for ratable basis recovery in transactions where the gross profit or the total contract price (or both) cannot be readily ascertained.

(l) The amendments to this section made during the 1985-86 Regular Session by the act adding this subdivision shall apply only to dispositions made after December 31, 1987.

SEC. 10. Section 24668 of the Revenue and Taxation Code is amended to read:

24668. (a) (1) Under rules prescribed by the Franchise Tax Board, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any income year that proportion of the installment payments actually received in that year which the gross profit, realized or to be realized when payment is completed, bears to the total contract price.

(2) For purposes of paragraph (1), the total contract price of all sales of personal property on the installment plan includes the amount of carrying charges or interest which is determined with respect to such sales and is added on the books of account of the seller to the established cash selling price of such property.

(b) If the carrying charges or interest with respect to sales of personal property, the income from which is returned under paragraph (1) of subdivision (a), is not included in the total contract price, payments received with respect to such sales shall be treated as applying first against such carrying charges or interest.

(c) (1) This section shall not apply to any of the following:

(A) Any disposition of personal property under a revolving credit plan.

(B) Any installment obligation arising out of a sale of either of the following:

(i) Stock or securities which are traded on an established securities market.

(ii) To the extent provided in regulations, property (other than stock or securities) of a kind regularly traded on an established market under regulations.

(2) This subdivision shall not apply to any sale of crops or livestock held for slaughter.

(3) The Franchise Tax Board may disallow the use of the installment method in whole or in part for transactions in which the rules of this section otherwise would be avoided through the use of related parties or other intermediaries.

(d) (1) The amendments to this section made during the 1985-86 Regular Session by the act adding this subdivision shall apply only to dispositions made after December 31, 1987.

(2) In the case of any taxpayer who made sales under a revolving credit plan and was on the installment method under Section 24668 for that taxpayer's last income year beginning before January 1, 1988, and who is required by the amendments to this section made during the 1985-86 Regular Session by the act adding this subdivision to change its method of accounting all of the following apply:

(A) That change shall be treated as initiated by the taxpayer.

(B) That change shall be treated as having been made with the consent of the Franchise Tax Board.

(C) The period for taking into account adjustments under Article 6 (commencing with Section 24721) by reason of that change shall not exceed five years.

SEC. 11. Section 24670 is added to the Revenue and Taxation Code, to read:

24670. (a) For purposes of Section 24667 and 24668, if a taxpayer has allocable installment indebtedness for any income year, that indebtedness —

(1) Shall be allocated on a pro rata basis to any applicable installment obligation of the taxpayer which meets both of the following requirements:

(A) Arises in that income year.

(B) Is outstanding as of the close of that income year.

(2) Shall be treated as a payment received on that obligation as of the close of that income year.

(b) For purposes of this section:

(1) "Allocable installment indebtedness" means, with respect to any income year:

(A) The installment percentage of the taxpayer's average quarterly indebtedness for that income year, reduced (but not below zero) by —

(B) The aggregate amount treated as allocable installment indebtedness with respect to applicable installment obligations which —

(i) Are outstanding as of the close of that income year, but

(ii) Did not arise during that income year.

(2) "Installment percentage" means the percentage (not in excess of 100 percent) determined by dividing:

(A) The face amount of all applicable installment obligations of the taxpayer outstanding as of the close of the income year, by —

(B) The sum of both of the following:

(i) The aggregate adjusted basis of all assets not described in clause (ii) held as of the close of the income year.

(ii) The face amount of all installment obligations outstanding as of that time.

For purposes of clause (i) of subparagraph (B), a taxpayer may elect to compute the aggregate adjusted basis of all assets using the deduction for depreciation which is used in computing earnings and profits under Section 24491.1.

(3) For purposes of this subdivision:

(A) There shall not be taken into account under subparagraph (B) of paragraph (2) any property used in the trade or business of farming (within the meaning of Section 2032(A)(e)(4) or (5) of the Internal Revenue Code) or any installment obligation arising from the sale of that property.

(B) There shall not be taken into account in computing the taxpayer's average quarterly indebtedness under subparagraph

(A) of paragraph (1) any indebtedness secured by any property described in subparagraph (A).

(c) (1) If any amount is treated as received under subdivision (a) (after application of paragraph (2) of subdivision (d)) with respect to any applicable installment obligation, subsequent payments received on that obligation shall not be taken into account for purposes of Sections 24667 and 24668 to the extent that the aggregate of those subsequent payments does not exceed the aggregate amount treated as received under subdivision (a).

(2) For purposes of applying subparagraph (B) of paragraph (1) of subdivision (b) for the income year in which any payment to which paragraph (1) of this subdivision applies was received, and for any subsequent income year, the allocable installment indebtedness with respect to the applicable installment obligation shall be reduced (but not below zero) by the amount of that payment not taken into account by reason of paragraph (1).

(d) (1) The amount treated as received under subdivision (a) with respect to any applicable installment obligation for any income year shall not exceed the excess (if any) of:

(A) The total contract price, over

(B) Any portion of the total contract price received under the contract before the close of that income year:

(i) Including amounts so treated under subdivision (a) for all preceding income years, but

(ii) Not including amounts not taken into account by reason of subdivision (c).

(2) If after application of paragraph (1), the allocable installment indebtedness for any income year exceeds the amount which may be allocated to applicable installment obligations arising in, and outstanding as of the close of, that income year, that excess shall, subject to the limitations of paragraph (1), be allocated to applicable installment obligations outstanding as of the close of that income year which arose in preceding income years, beginning with applicable installment obligations arising in

the earliest preceding income year and shall be treated as a payment under paragraph (2) of subdivision (a).

(e) (1) "Applicable installment obligation" means any obligation which meets both of the following requirements:

(A) Arises from the disposition after December 31, 1987, of any of the following:

(i) Personal property under the installment method by a person who regularly sells or otherwise disposes of personal property on the installment plan.

(ii) Real property under the installment method which is held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business.

(iii) Real property under the installment method which is property used in the taxpayer's trade or business or property held for the production of rental income, but only if the sales price of that property exceeds one hundred fifty thousand dollars ($150,000). All sales and exchanges which are part of the same transaction (or a series of related transactions) shall be treated as one sale or exchange.

(B) Is held by the seller or a member of the same affiliated group as the seller.

(2) For purposes of this section, all members of-

(A) An affiliated group (within the meaning of Section 1504(a) of the Internal Revenue Code, but without regard to Section 1504(b) of the Internal Revenue Code), or

(B) A group under common control (within the meaning of Section 52(b) of the Internal Revenue Code), shall be treated as one taxpayer. The Franchise Tax Board may prescribe regulations for the treatment under this section of transctions between members of these groups.

(3) The Franchise Tax Board may provide that all (or any portion of) applicable installment obligations of a taxpayer may be treated as one obligation.

(4) (A) If a taxpayer elects the application of this paragraph, this section shall not apply to any installment obligation which meets both of the following requirements:

(i) Arises from a sale in the ordinary course of the taxpayer's trade or business to an individual of either of the following:

(I) A timeshare right to use or a timeshare ownership interest in residential real property for not more than six weeks, or a right to use specified campgrounds for recreational purposes.

(II) Any residential lot but only if the taxpayer (or any related person) is not to make any improvements with respect to that lot.

(ii) Is not guaranteed by any person other than an individual.

(B) If subparagraph (A) applies to any installment obligation, interest shall be paid on the portion of any tax for any income year (determined without regard to any deduction allowable for that interest) which is attributable to the receipt of payments on that obligation in that year (other than payments received in the income year of the sale). That interest shall be computed for the period from the date of the sale to the date on which the payment is received using the federal short-term rate under Section 1274 of the Internal Revenue Code (compounded semiannually) in effect at the time of the sale and adjusted annually to the federal short-term rate in effect on each anniversary of the sale.

(C) Any interest payable under this paragraph with respect to a payment shall be treated as an addition to tax for the income year in which the payment is received, except that the amount of that interest shall be taken into account in computing the amount of any deduction allowable to the taxpayer for interest paid or accrued during that income year.

(5) Except as otherwise provided, a shareholder who (after appication of Section 318 of the Internal Revenue Code) owns stock in a corporation meeting the requirements of Section 1504(a)(2) of the Internal Revenue Code shall be treated as a member of the affiliated group.

(6) The Franchise Tax Board may disallow the use of the installment method in whole or in part for transactions in which

the rules of this subdivision otherwise would be avoided through the use of related parties or other intermediaries.

(f) (1) Except as otherwise provided, this section shall apply to income years beginning after December 31,1987, with respect to dispositions after December 31, 1987.

(2) (A) This section shall not apply to any installment obligation arising from the disposition of tangible personal property by a manufacturer (or any taxpayer owned or controlled by the same interest, as defined by Section 25102) to a dealer if all of the following requirements are met:

(i) The dealer is obligated to pay on that obligation only when the dealer resells (or rents) the property.

(ii) The manufacturer has the right to repurchase the property at a fixed (or ascertainable) price after no later than the 9-month period beginning with the date of the sale.

(iii) The disposition is in an income year with respect to which the requirements of subparagraph (B) are met.

(B) The requirements of this subparagraph are met with respect to any income year if for that income year and the preceding income year the aggregate face amount of installment obligations described in subparagraph (A) is at least 50 percent of the total sales to dealers giving rise to those obligations, except that if the taxpayer met the requirements of this subparagraph for the preceding income year, then the taxpayer shall be treated as failing to meet the requirements of this subparagraph only in the second consecutive income year in which the 50-percent test is not met.

(C) An obligation issued before the date of the enactment of this section shall be treated as described in subparagraph (A) if, within 60 days after that date, the taxpayer modifies the terms of the obligation to conform to the requirements of subparagraph (A).

(D) In applying this section, any obligations described in subparagraph (A) shall not be treated as applicable installment

obligations (within the meaning of subparagraph (A) of paragraph (1) of subdivision (e)).

(E) This paragraph shall apply only if the taxpayer meets the requirements of subparagraphs (A) and (B) for its first income year beginning after the date of enactment of this section.

(3) In applying this section to any installment obligation of a corporation incorporated on January 13, 1928, the following indebtedness shall not be taken into account in determining the allocable installment indebtedness of that corporation under this section:

(A) Twelve and five-eighths percent subordinated debentures, with a total face amount of one hundred seventy-five million dollars ($175,000,000) issued pursuant to a trust indenture dated as of September 1, 1985.

(B) A revolving credit term loan in the maximum amount of one hundred thirty million dollars ($130,000,000) made pursuant to a revolving credit and security agreement dated as of September 6, 1985, payable in various stages with final payment due on August 31, 1992.

This paragrpah shall also apply to indebtedness which replaces indebtedness described in this paragraph if that indebtedness does not exceed the amount and maturity of the indebtedness it replaces.

SEC. 12. Section 25110 of the Revenue and Taxation Code is amended and renumbered to read:

25108. (a) For corporations whose income is subject to the provisions of Section 25101 or 25101.15, the net operating loss determined in accordance with Section 172 of the Internal Revenue Code, as modified by Section 24416, for a particular income year (taxable year of corporations subject to the tax imposed by Chapter 3) shall be the corporation's "net loss for state purposes" as defined in subdivision (c).

(b) The net operating loss deduction allowed by Section 24416 for an income year (taxable year of corporations subject to the tax imposed by Chapter 3) shall be deducted from "net income for

state purposes" (as defined in subdivision (c)) for that income year (taxable year of corporations subject to the tax imposed by Chapter 3.

(c) "Net income (loss) for state purposes" means the sum of the net income or loss of that corporation apportionable to this state and the income or loss allocable to this state as nonbusiness income, as provided by Chapter 17 (commencing with Section 25101).

SEC. 6. Article 1.5 (commencing with Section 25110) is added to Chapter 17 of Part 11 of Division 2 of the Revenue and Taxation Code, to read:

Article 1.5. Water's-Edge Election

25110. (a) Notwithstanding Section 25101, a qualified taxpayer, as defined in paragraph (2) of subdivision (b) which is subject to the tax imposed under this part, may elect to determine its income derived from or attributable to sources within this state pursuant to a water's-edge election in accordance with the provisions of this part, as modified by this article. A taxpayer which makes a water's-edge election shall take into account the income and apportionment factors of the following affiliated entities only:

(1) Affiliated banks or corporations which are eligible to be included in a federal consolidated return as described in Sections 1501 to 1505, inclusive, of the Internal Revenue Code.

(2) Domestic international sales corporations, as described in Sections 991 through 994 of the Internal Revenue Code and foreign sales corporations as described in Sections 921 through 927 of the Internal Revenue Code.

(3) Any corporation, regardless of the place where it is incorporated if the average of its property, payroll, and sales factors within the United States is 20 percent or more.

(4) Banks and corporations which are incorporated in the United States, excluding corporations described in Sections 931 to 936, inclusive, of the Internal Revenue Code, of which more

than 50 percent of their stock is controlled directly or indirectly by the same interests, which are not included in paragraph (1).

(5) A bank or corporation which is not described in paragraphs (1) to (4), inclusive, or paragraph (6), but only to the extent of its income derived from or attributable to sources within the United States and its factors assignable to a location within the United States in accordance with paragraph (3). Income of such a bank or corporation derived from or attributable to sources within the United States shall be limited to and determined from the books of account maintained by the bank or corporation with respect to its activities conducted within the United States as determined by federal income tax law.

(6) Export trade corporations, as described in Sections 970 to 972, inclusive, of the Internal Revenue Code.

(7) (A) (A) The income and factors of the above-enumerated banks and corporations shall be taken into account only if the income and factors would have been taken into account under Section 25101 if this section had not been enacted.

(B) The income and factors of a bank which is not described in paragraphs (1) to (4), inclusive, and (6) and which is an electing taxpayer under this subdivision shall be taken into account in determining its income only to the extent set forth in paragraph (5).

(8) Any affiliated bank or corporation which is a "controlled foreign corporation", as defined in Section 957 of the Internal Revenue Code, if all or part of the income of that affiliate is defined in Section 952 of Subpart F of the Internal Revenue Code ("Subpart F income"). The income and apportionment factors of any affiliate to be included under this paragraph shall be determined by multiplying the income and apportionment factors of that affiliate without application of this paragraph by a fraction (not to exceed one), the numerator of which is the "Subpart F income" of that bank or corporation and the denominator of which is the "earnings and profits" of that bank or corporation, as defined in Section 964 of the Internal Revenue Code.

(b) For purposes of this section:

(1) An "affiliated bank or corporation," for purposes of this article, means a bank or corporation which is part of one or more chains of banks or corporations connected through stock ownership with a common parent if both of the following exist:

(A) Over 50 percent of the voting stock of the bank or corporation is directly or indirectly owned or controlled by one or more of the other banks or corporations.

(B) The common parent owns directly or indirectly over 50 percent of the voting stock of at least one of the other banks or corporations.

(2) A "qualified taxpayer" means a bank or corporation which does both of the following:

(A) Files with the state tax return on which the water's-edge election is made a consent to the taking of depositions from key domestic corporate individuals and to the acceptance of subpoenas duces tecum requiring reasonable production of documents to the Franchise Tax Board as provided in Section 26423 or by the State Board of Equalization or by the courts of this state. The consent shall remain in effect so long as the water's-edge election is in effect and shall be limited to providing that information necessary to review or to adjust income or deductions in a manner authorized under Sections 482, 861, Subpart F of Part III of Subchapter N, or similar provisions of the Internal Revenue Code, together with the regulations adopted pursuant thereto, and for the conduct of an investigation with respect to any unitary business in which the taxpayer may be involved.

(B) Agrees that for purposes of this article, dividends received by any bank or corporation whose income and apportionment factors are taken into account pursuant to subdivision (a) from either of the following shall be deemed to be functionally related dividends subject to Section 24111 and shall be presumed to be business income:

(i) A bank or corporation of which more than 50 percent of the voting stock is owned, directly or indirectly, by members of

the unitary group and which is engaged in the same general line of business.

(ii) Any bank or corporation which is either a significant source of supply for the unitary business or a significant purchaser of the output of the unitary business, or which sells a significant part of its output or obtains a significant part of its raw materials or input from the unitary business. "Significant," as used in this subparagraph, means an amount of 15 percent or more of either input or output.

All other dividends shall be classified as business or nonbusiness income without regard to this subparagraph.

(3) The definitions and locations of property, payroll, and sales shall be determined under the laws and regulations which set forth the apportionment formulas used by the individual states to assign net income subject to taxes on or measured by net income in that state. If a state does not impose a tax on or measured by net income or does not have laws or regulations with respect to the assignment of property, payroll, and sales, the laws and regulations provided in Article 2 (commencing with Section 25120) shall apply.

Sales shall be considered to be made to a state only if the bank or corporation making the sale may otherwise be subject to a tax on or measured by net income under the Constitution or laws of the United States, and shall not include sales made to a bank or corporation whose income and apportionment factors are taken into account pursuant to their subdivision.

(4) The Franchise Tax Board, for purposes of administering the provisions of Sections 25110 and 15115, shall examine the returns filed by taxpayers subject to these provisions. Where this examination reveals potential noncompliance, a detailed examination shall be made notwithstanding the potential net revenue benefit to the state unless the taxpayer is being examined by the Internal Revenue Service for the same year or years on the same issues.

In any case of two or more organizations, trades, or businesses (whether or not organized in the United States and whether or

not affiliated) owned or controlled directly or indirectly by the same interests, the Franchise Tax Board may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among these organizations, trades, or business, if the board determines that the distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of these organizations, trades, or businesses.

In making distributions, apportionments, and allocations under this section, the Franchise Tax Board shall generally follow the rules, regulations, and procedures of the Internal Revenue Service in making audits under Section 482 of the Internal Revenue Code. Any of these rules, regulations, and procedures adopted by the Franchise Tax Board shall not be subject to review by the Office of Administrative Law.

If the Internal Revenue Service has conducted a detailed audit under Section 482 of the Internal Revenue Code and has made adjustments pursuant to that section, it shall be presumed that no further adjustments are necessary for this state's purposes. If the Internal Revenue Service has conducted a detailed audit under this section and has made or proposed no adjustments to the transaction examined, it shall be presumed that no adjustment is necessary for this state's purposes. These presumptions shall be overcome if the Franchise Tax Board or the taxpayer demonstrates that an adjustment or a failure to make an adjustment was erroneous, if it demonstrates that the results of such an adjustment would produce a minimal tax change for federal purposes because of correlative or offsetting adjustments or for other reasons, or if substantially the same federal tax result was obtained under other sections of the Internal Revenue Code. No inference shall be drawn from an Internal Revenue Service failure to audit international transactions under Section 482 of Internal Revenue Code and it shall not be presumed that any such transactions were correctly reported.

(5) "The United States" means the 50 states of the United States and the District of Columbia.

(c) All references in this part to income determined pursuant to Section 25101 shall also mean income determined pursuant to this section.

(d) A water's-edge election may be disregarded by the Franchise Tax Board only if any of the following occurs:

(1) A bank or corporation fails to comply substantially with Section 25114 or any federal law requiring the filing of domestic spreadsheets.

(2) After a reasonable adjustment of transfer prices, royalty rates, the allocation of common expenses, and similar adjustments, the return filed pursuant to this section fails to prevent the evasion of taxes.

(3) An otherwise qualified taxpayer fails to do any of the following:

(A) Retain and make available upon request the documents and information, including any questionnaires completed and submitted to the Internal Revenue Service or qualified states, which are necessary to audit issues involving attribution of income to the United States or foreign jurisdictions under Sections 482, 861, 863, 902, 904, and Subpart F of Part III of Subchapter N, or similar sections of the Internal Revenue Code.

(b) Identify, upon request, principal officers or employees who have substantial knowledge of and access to documents and records which discuss pricing policies, profit centers, cost centers, and the methods of allocating income and expense among these centers. The information shall include the employees' titles and addresses.

(C) Retain and make available upon request all documents and correspondence ordinarily available to a bank or corporation included in the water's-edge election which are submitted to or obtained from the Internal Revenue Service, foreign countries or their territories or possessions, and competent authority pertaining to ruling requests, rulings, settlement resolutions, and competing claims involving jurisdictional assignment and sourcing of income that affect the assignment of income to the United States. The documents shall include all ruling requests and rulings on reorganizations involving foreign incorporation of branches, all ruling requests and rulings on changing a bank or corporation's jurisdictional incorporation, and all documents which are ordinarily available to a bank or corporation included in the water's-edge election which pertain to the determination of foreign tax liability, including examination reports issued by foreign taxing administrations. If the documents have been translated, the translations shall be furnished.

(D) Prepare and make available upon request for each bank or corporation included in the disclosure spreadsheet referred to in subdivision (a) of Section 25114 in which the taxpayer is included, a list of each state of the United States, including the District of Columbia, territories or possessions, and each foreign country in which it has payroll, property, or sales. The sales shall be determined by destination whether or not the taxpayer is taxable in the destination jurisdiction.

(E) Retain and make available upon request forms filed with the Internal Revenue Service to comply with Sections 6038, 6038A, and 6041 of the Internal Revenue Code.

(F) Prepare and make available upon request, for each bank or corporation organized or created under the laws of the United States or a political subdivision thereof, of which 50 percent or more of its voting stock is directly or indirectly owned or controlled, the information which would be included in the forms described in subparagraph (E) if those forms were required for United States corporations.

(G) Retain and make available upon request all state tax returns filed by each bank or corporation included under subdivision (a) in each state, including the District of Columbia.

(H) Comply with reasonable requests for discovery directed at obtaining information necessary to determine or verify its net income, apportionment factors, or the geographic source of that income pursuant to the Internal Revenue Code.

(I) For purposes of this subdivision, information for any year shall be retained for that period of time in which the taxpayer's income or franchise tax liability to this state may be subject to

adjustment, including all periods in which additional income or franchise taxes may be assessed or during which an appeal is pending before the State Board of Equalization or a lawsuit is pending in the courts of this state or the United States with respect to California franchise or income tax.

(4) A failure to satisfy any of the requirements of paragraph (3) shall mean a willful failure to retain and make available documents that are material to a determination by the Franchise Tax Board of a qualified taxpayer's tax under this part.

25111. (a) A water's-edge election shall be made by contract with the Franchise Tax Board in the original return for a year and shall be effective only if every affiliated bank or corporation subject to tax under this part consents to the election. Consent by the common parent of an affiliated group shall constitute consent of all members of the group. The form and manner of making the water's-edge election shall be prescribed by the Franchise Tax Board. Each contract making a water's-edge election shall be for an initial term of 10 years, except as provided in subdivision (b). Each contract shall provide that on the anniversary date of the contract or any other annual date specified by the contract a year shall be added automatically to the initial term unless notice of nonrenewal is given as provided in subdivision (d). Each contract shall be conditioned by an agreement to pay the amount specified in Section 25115. Except as provided in subdivision (b), the Franchise Tax Board shall enter into a contract as provided by this section with any qualified taxpayer which wishes to make a water's-edge election. An affiliated bank or corporation which becomes subject to tax under this part subsequent to the water's-edge election shall be deemed to have consented to the election. No water's-edge election shall be made for an income year beginning prior to the operative date of this article.

(b) A water's-edge election may be disregarded by the Franchise Tax Board as provided in subdivision (d) of Section 25110 and may be changed by a taxpayer prior to the end of the 10-year period only with the permission of the Franchise Tax Board.

(c) In disregarding an election or in granting a change of election, the Franchise Tax Board shall impose any conditions which are necessary to prevent the avoidance of tax or clearly reflect income for the period the election was, or was purported to be, in effect. These conditions may include a requirement that income, including dividends paid from income earned while a water's-edge election was in effect, which would have been included in determining the income of the taxpayer from sources within and without this state pursuant to Section 25101 but for the water's-edge election shall be included in income in the year in which the election is changed or disregarded.

(d) If the taxpayer desires in any year not to renew the contract, the taxpayer shall serve written notice of nonrenewal of the contract upon the board in advance of the annual renewal date of the contract. Unless that written notice is served by the taxpayer at least 90 days prior to the renewal date, the contract shall be considered renewed as provided in subdivision (a).

If the taxpayer serves notice of intent in any year not to renew the contract, the existing contract shall remain in effect for the balance of the period remaining since the original execution or the last renewal of the contract, as the case may be.

25112. (a) If a taxpayer electing under Section 25110 fails to supply any required information, in addition to being subject to disqualification by the Franchise Tax Board pursuant to Section 25110 and to any penalties otherwise provided by this part, the taxpayer shall pay a penalty of one thousand dollars ($1,000) for each income year with respect to which the failure occurs.

(b) If the failure continues for more than 90 days after the date on which the Franchise Tax Board mails notice of that failure to the taxpayer, the taxpayer shall pay a penalty (in addition to the amount required under subdivision (a)) of one thousand dollars ($1,000) for each 30-day period (or fraction thereof) during which the failure continues after the expiration of the 90-day period. The increase in any penalty under this subdivision shall not exceed twenty-four thousand dollars ($24,000).

(c) If the taxpayer fails to comply substantially with any formal document request arising out of the examination of the tax

treatment of any item (hereinafter in this section referred to as the "examined item") before the 90th day after the date of the mailing of the request, any court having jurisdiction of a civil proceeding in which the tax treatment of the examined item is an issue shall, upon motion by the Franchise Tax Board, prohibit the introduction by the taxpayer of any documentation covered by that request.

(d) For purposes of this section, the time in which information is to be furnished (and the beginning of the 90-day period after notice by the Franchise Tax Board) shall be treated as beginning not earlier than the last day on which reasonable cause existed for failure to furnish the information.

(e) This section shall not apply with respect to any requested documentation if the taxpayer establishes that the failure to provide the documentation, as requested by the Franchise Tax Board, is due to reasonable cause. For purposes of subdivision (c), the fact that a foreign jurisdiction would impose a civil or criminal penalty on the taxpayer (or any other person) for disclosing the requested documentation is not reasonable cause.

(f) For purposes of this section, the term "formal document request" means any request (made after the normal request procedures have failed to produce the requested documentation) for the production of documentation which is mailed by registered or certified mail to the taxpayer at its last known address and which sets forth all of the following:

(1) The time and place for the production of the documentation.

(2) A statement of the reason the documentation previously produced (if any) is not sufficient.

(3) A description of the documentation being sought.

(4) The consequences to the taxpayer of the failure to produce the documentation described in this section.

(g) Notwithstanding any other law or rule of law, any taxpayer to whom a formal document request is mailed may begin a proceeding to quash that request not later than the 90th day after

the date the request was mailed. In any such proceeding, the Franchise Tax Board may seek to compel compliance with the request.

(h) The superior courts of the State of California for the Counties of Los Angeles, Sacramento, and San Diego, and for the City and County of San Francisco shall have jurisdiction to hear any proceeding brought under subdivision (g). An order denying the petition shall be deemed a final order which may be appealed.

The running of the 90-day period referred to in subdivision (b) shall be suspended during any period during which a proceeding brought under subdivision (g) is pending.

(i) For purposes of this section, "documentation" means any documentation which may be relevant or material to the tax treatment of the examined item.

(j) The Franchise Tax Board, and any court having jurisdiction over a proceeding under subdivision (g), may extend the 90-day period referred to in subdivision (b).

(k) If any bank or corporation takes any action as provided in subdivision (g), the running of any period of limitations under Sections 25663 to 25663d, inclusive (relating to the assessment and collection of tax), or under Section 25964 (relating to criminal prosecutions) with respect to that bank or corporation shall be suspended for the period during which the proceedings under subdivision (g) and appeals thereto are pending.

25113. (a) In any administrative or judicial proceeding, the Franchise Tax Board may introduce into evidence the record of any final court determination in another state involving the same taxpayer or a unitary business of which the taxpayer is alleged to be a member.

(b) Tax information pertaining to the examination of multinational operations, including underlying data, obtained from the Internal Revenue Service or a foreign government shall be admissible into evidence in an administrative or judicial proceeding involving a taxpayer's liability under this part without being contestable as to its relevancy.

25114. Any bank or corporation required to file a United States tax return or which could be included in a consolidated federal tax return shall file with the Franchise Tax Board within three months after the bank or corporation files its federal income tax return a domestic disclosure spreadsheet if it and its related corporation's payroll, property, or sales in a foreign country exceeds one million dollars ($1,000,000) or if it and its related corporation's total assets exceed two hundred fifty million dollars ($250,000,000), or such higher levels as may be subsequently established by regulation. For purposes of this paragraph, two corporations are related if more than 50 percent of the voting stock of one company is directly or indirectly owned or controlled by the other or if more than 50 percent of the voting stock of both is directly or indirectly owned or controlled by the same interest. The spreadsheet shall provide for full disclosure as to the income reported to each state, the state tax liability, and the method used for apportioning or allocating income to the states, and any other information as provided for by regulations as may be necessary to determine properly the amount of taxes due to each state and to identify the corporate parent and those of its affiliates of which more than 20 percent of the voting stock is directly or indirectly owned or controlled by the parent. The spreadsheet shall be reviewed for completeness by the Franchise Tax Board and if it is not properly completed shall not be accepted and shall be subject to penalties.

25115. (a) Each contract described in Section 25111 shall provide that a taxpayer making a water's-edge election pursuant to this article shall pay an annual amount to the Franchise Tax Board for deposit in the California Unitary Fund created pursuant to Section 16429.30 of the Government Code. One-third of the amount shall be deposited in the Local Project Account for Non-Transient Spending in the California Unitary Fund, and two-thirds of the amount shall be deposited in the Future Infrastructure State Targeted Account in the California Unitary Fund.

(b) The amount shall be equal to thirty-thousandths of 1 percent of the sum of the taxpayer's property, payroll, and sales in

this state, as defined in this chapter, with the following adjustments:

(1) Intangibles shall not be included in the property factor.

(2) The property and payroll factors shall be with respect to the income year ending during calendar year 1986.

(3) The sum of the property, payroll, and sales shall be reduced by the cumulative amount expended since January 1, 1988, for investment in new plants or facilities in this state, as defined in subdivision (c), and shall further be reduced by the amount expended for new employees in this state as defined in subdivision (e).

(c) A new plant or facility is property described in Section 70, provided that it is not a replacement, in whole or in part, for an existing plant or facility in this state. A plant or facility shall be deemed a replacement if the taxpayer, or an affiliated bank or corporation, as defined in paragraph (1) of subdivision (b) of Section 25110, closes, takes out of service, sells, or leases to an unrelated party, in either the three immediately preceding or the three immediately succeeding years from the time the new plant or facility is operational, a plant or facility with a cost basis equal to 25 percent or more of the cost basis of the new plant or facility.

(d) The number of new employees in this state for any income year shall be determined by comparing the total number of work years in this state for the income year to the greater of (1) the average of the total number of work years in this state for the income years ending in 1985, 1986, and 1987, or (2) the total number of work years in this state for the income year ending in 1987. A "work year" means, in the case of workers who are paid an hourly wage, 2,000 paid hours, and in the case of salaried employees, a total of 12 paid months.

(e) The amount expended for new employees shall be equal to the product of the number of new employees determined pursuant to subdivision (d) and the average wages paid for each work year in this state for the income year.

(f) Each contract shall provide that the amount described in this section shall not be subject to any statutory changes, for the

period the contract is in effect, without the consent of the taxpayer. Any statutory change shall be applicable for any renewal year beginning 10 years after that statutory change.

(g) Amounts determined pursuant to this section shall be collected in the same manner as the taxes imposed by this part and shall be subject to interest and penalties as provided in this part.

(h) In no event shall the amount determined pursuant to this section be less than ten-thousandths of the sum of the taxpayer's property, payroll, and sales in this state for the current year.

(i) The annual amount otherwise determined pursuant to this section and payable under a contract described in Section 25111 shall not be imposed for an income year in which a taxpayer incurs no tax liability under Sections 25101 and 25110.

SEC. 14. The Franchise Tax Board shall study its current auditing practices and those of the Internal Revenue Service for so-called 80-20 corporations, and the equity of the treatment of those corporations pursuant to this act. The Franchise Tax Board shall present a report to the Legislature no later than March 1, 1987, which identifies additional authority needed, if any, to adequately audit so-called 80-20 corporations if those corporations were outside the water's edge and which sets forth its findings with respect to the equity treatment.

SEC. 15. This act shall become operative on January 1, 1988. The provisions of this act shall be applicable in the computation of taxes for income years commencing on or after January 1, 1988.

EXHIBIT 56

H. M. TREASURY
Parliament Street, London SW1P 3AG
Press Office: 01-233 3415
Telex: 262405

5 September 1986

UNITARY TAX

The Government welcome the passage of legislation in California limiting the use of worldwide unitary taxation.

This is a major step towards the complete withdrawal of this method of taxation, which both the Government and representatives of British industry have been seeking for some time. In the last two years there has been action to reform unitary tax in a number of states. But the California legislation is particularly significant in view of the size of the State's economy and its importance to the UK as a location for investment.

The government have reservations about some aspects of the California Legislation, and will continue to look for a comprehensive solution to this problem as outlined by the President in his Statement last November. They acknowledge the important contributions of the federal government in working towards unitary tax reform and will seek its continued support in the unitary tax court cases. The Government are also discussing with the US authorities the future of the Unitary Tax Bill now before Congress and the prospects for amendment to the UK/US Double Taxation Convention.

PRESS OFFICE
H M TREASURY
PARLIAMENT STREET
LONDON SW1P 3AG

113/86

Notes for Editors

The internationally accepted principle is that tax authorities charge tax on foreign-owned companies only on the profits arising in the country or state for which they are responsible. However, a number of US states tax foreign-owned companies on a conventional share of the worldwide income of the Group. This means, for example, that a UK group operating in California may have to pay tax on income arising outside the state, giving rise to double taxation. It may also face heavy compliance costs in furnishing details of its worldwide operations.

2. The UK Government has consistently opposed the application of unitary taxation to international business. So has the CBI. So have many other countries. It is contrary to internationally accepted principles and results in unreasonable tax and compliance burdens.

3. In 1979 the US Senate rejected the provision (Article 9(4)) included in the US/UK double taxation agreement, as signed, which would have prevented US states from applying the unitary method to UK companies with US subsidiaries.

4. In July 1984, a Working Group under the Chairmanship of (then) US Treasury Secretary Regan, agreed on the principle that unitary taxation should be limited to the United States water's edge, but failed to resolve a number of issues. Secretary Regan said in his Chairman's Report, (July 1984), that if there were not "sufficient signs of appreciable progress" at states level by 31 July 1985, he would recommend to the President that the Administration should propose federal legislation.

5. Since July 1984, there has been action to reform unitary tax in a number of states — Oregon, Florida, Massachusetts, Indiana, Utah, Colorado, New Hampshire, Idaho and now California — though in some cases the application of unitary tax to foreign-owned corporations is limited and not eliminated. Legislative initiatives have not succeeded in the remaining three states which apply unitary tax to foreign-owned business (Alaska, North Dakota and Montana).

6. In July 1985, Parliament passed a provision (Section 54, Finance Act 1985), under which the UK could withdraw from US parent companies situated in unitary states, the entitlement to tax credits relating to dividends paid by UK subsidiaries. This provision would take effect by statutory instrument, subject to affirmative resolution of the House of Commons.

7. Last November, HM Government and the US President, issued statements on plans to resolve the unitary tax issue. These were followed in December by the publication of draft federal legislation in the US. Hearings are scheduled on this draft legislation later this month.

8. It is understood that the Californian legislation would allow companies to elect not to have their California tax assessment made on the worldwide unitary basis. However, companies so electing would have to pay an election fee. In addition, the Californian tax authorities would still retain powers to impose the use of worldwide unitary taxation in certain circumstances.

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EXHIBIT 72K

10 DOWNING STREET

THE PRIME MINISTER 8 November 1983

Dear Michael

Thank you for your letter of 6 October. You will since have received mine of 7 October, in which I told you of my discussion with President Reagan and Treasury Secretary Regan about Unitary Taxation. I am grateful for what you say about the way I dealt with this issue in Washington.

It was of course a disappointment that the President has decided not to take action to sponsor or support legislation prohibiting Unitary Taxation but instead to place the matter in the hands of a Working Group. But you may be pessimistic in assuming that this will freeze any further activity indefinitely: we have been assured that the Working Group are under instructions not to delay their deliberations. You may like to know that HMG has now been invited to make representations to the Commission.

We shall of course also continue to remind the Administration of our very strong concern over the matter. I have no doubt that British businesses will continue to do so as well. This can only be helpful.

Nigel Lawson also raised the question with our Community partners when he was in Luxembourg last week. He received general support from his colleagues, and as a result further consideration is being given to ways to concert Community action in Washington.

Margaret Thatcher

Michael Grylls, Esq., M.P.

EXHIBIT 75

Summary of Cost Compliance

Bernard L. Caldwell

18 Calif. Admin. Code 25737-6

Barclays Bank

		000's
Set-Up Costs		$3,400(1)
Systems Costs		3,000(2)
Annual Compliance Cost	$1,700(3)	
Annual Maintenance and Training Cost	300(4)	
Total Annual Cost		$2,000
Total Compliance Cost		$8,400

(1) Estimate based upon a factor of 2 times the annual compliance costs.

(2) Based on 1979 mechanization work for a large multinational corporation, considering a 25% increase in costs over the 7 years.

(3) Based on cost comparison of the estimated state compliance costs of a large multinational financial corporation plus an additional amount to take into account the effort required by BBPLC due to no synergism associated with a U.S. filing requirement by the comparable bank. Estimated additional costs 35-50%.

(4) Estimated to run at 20% of annual compliance.

EXHIBIT RR

RETURN ROUTING AND CONTROL FORM

Taxpayer's Name Barclays Bank International, Ltd.

Code Number 06915-015

☐ Computer Process
☒ Manual

☒ Corporate (Bank)
☐ Partnership
☐ Fiduciary
☐ Individual
☐ Exempt Organization
(Other) ______________

* SHOW ALL TIME CHARGED

	1972		
	Last Name	Date Comp-leted	*Time
Interviewed Client			
Prepared	Haney	6/1/73	13*+1
Reviewed	[illegible]	6/12/73	4
Computax Reviewed (If Applicable)	—		—
Typed			
Proofread			
Processed	Honi	6/13/73	1
Assembly Checked by Reviewer	[illegible]	6/13/73	—
Manager Review & Approval for Signature	Vickrey	6/13/73	2
Signed & Dated	[illegible]	6/13/73	

Safe Yes ☐
Declarations No ☐

Special Instructions/Explain high or low time charges below.

* Data submitted less complete than [illegible], correction made by client causing correction in PW work.

Price Waterhouse

197_			9/30 1974		
Last Name	Date Comp-leted	*Time	Last Name	Date Comp-leted	*Time
Anderson	6/3/74	10	Koch	6/4/75	10+1
Rickey			Anderson	6/7/75	2+1
—		—			
Honi	6/7	1	KK	6/7/75	1
Anderson	6/7/74	1	Anderson	6/10/75	1
Vickrey	6/7/74		[illegible]	6/9/75	2
[illegible]	6/7/74		NCO	6/11/75	1

Safe Yes ☐
Declarations No ☐

Special Instructions/Explain high or low time charges below.

Safe Yes ☐
Declarations No ☐

Special Instructions/Explain high or low time charges below.

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R.W. Vickrey: ad **COPY—SAN FRANCISCO** Taxes

EXHIBIT SS-1

June 13, 1973

HAND DELIVERED
Barclays Bank International, Ltd.
111 Pine Street
San Francisco, California 94111

Attention: Mr. Robert E. Gilbert

Dear Sirs:

CALIFORNIA FRANCHISE TAX RETURN
YEAR ENDED SEPTEMBER 30, 1972

In accordance with your instructions, we have prepared and enclose, in duplicate, California franchise tax return for the year ended September 30, 1972 for Barclays Bank International, Ltd. showing a tax of $2,599 and an overpayment of $901, of which $850 will be credited to the revised third and fourth instalments of estimated tax or the year ending September 30, 1973 and $51 will be refunded.

The return has been prepared on the basis of reporting the world-wide income of Barclays Bank International and allocating a portion of that income to the California Agency according to the standard allocation formula for banks. As in prior returns, no detail of the world-wide income is provided in the return. Upon examination, an agent could request a more detail analysis of income and expense in arriving at the world-wide income of $98,749,473. Upon review and approval, the return should be filed in accordance with the instructions attached to the duplicate copy of the return.

CALIFORNIA DECLARATION OF ESTIMATED TAX
INCOME YEAR ENDING SEPTEMBER 30, 1973

We have reviewed the California estimated tax declaration and have prepared and enclose, in duplicate, a revision of the third and fourth instalments to reflect the overpayment mentioned above. Instructions for filing are attached to the duplicate copy of the declaration.

Yours very truly,

Enclosures—
Tax return
Declaration

EXHIBIT SS-2

June 7, 1974

Price,
Waterhouse & Co.

555 California Street
San Francisco, California 94104
415-392-1032

HAND DELIVERED
Barclays Bank International, Ltd.
111 Pine Street
San Francisco, California 94111

Attention: Mr. Robert E. Gilbert

Dear Sirs:

CALIFORNIA FRANCHISE TAX RETURN
YEAR ENDED SEPTEMBER 30, 1973

In accordance with your instructions, we have prepared and enclosed, in duplicate, California franchise tax return for the year ended September 30, 1973 for Barclays Bank International, Ltd. (BBI) — California Agency showing a tax of $6,973 and an overpayment of $7,027.

The return has been prepared on the basis of reporting the worldwide income of Barclays Bank International, Ltd. and allocating a portion of that income to the BBI — California Agency according to the standard allocation formula for banks. As in prior returns, no detail of the worldwide income is provided in the return. Upon examination, an agent could request a more detailed analysis of income and expense in arriving at the worldwide income of $84,793,923. In addition, the following items regarding the determination of the California Agency allocable income should be noted:

1. The California Franchise Tax Board (FTB) may assert that pre-tax profits as outlined by the Barclays International Group consolidated profit and loss report should be used in determining worldwide net income rather than the "grossed-up" after-tax net income total which was provided by your London office and was utilized in the tax return calculations.

2. The resources factor was calculated without consideration of the following items as the worldwide information was not available:

a. The Reserve for loan losses was deducted in arriving at total resources although normal practice would be to exclude it.

b. The rent factor (8 × rents) was not included as an addition to total resources, although normal practice would be to include it.

In addition, the FTB may assert that property should be stated at original cost exclusive of depreciation, including fully-depreciated property still in use. At present, the property used in the resources calculation is stated at book value which apparently includes some revaluation.

3. The BBI — California Agency resources during the year ending September 30, 1973 increased from a beginning balance of $1,764,238 to an ending balance of $22,681,566 due to large loans carried on the Agency's books. If these loans had been carried on the books of a non-California BBI branch causing resources in the BBI — California Agency to remain relatively constant during the year, the California tax liability of the Agency would have decreased approximately $3,000.

4. As discussed with you, we have treated salaried personnel charged against the BBI — California Agency operations as employees of Barcal. Accordingly, for purposes of the allocation factor calculations these salaries are included as "management fees" and no salaries are listed for the Agency.

CALIFORNIA DECLARATION OF ESTIMATED TAX
INCOME YEAR ENDING SEPTEMBER 30, 1974

We have reviewed the requirements of BBI — California Agency for paying California estimated tax payments for the year ending September 30, 1974 and have determined that no additional payments are required. The estimated tax payments made with Vouchers 1 and 2 ($8,000) are already in excess of the prior year's tax liability.

Upon review and approval, the return should be filed in accordance with the instructions attached to the duplicate copy of the return.

Yours very truly,
PRICE WATERHOUSE & CO.

Enclosure—
Tax return

Price
Waterhouse & Co.

EXHIBIT SS-3

June 10, 1975

Price,
Waterhouse & Co.

555 California Street
San Francisco, California 94104
415-392-1032

HAND DELIVERED

Barclays Bank International, Ltd.
111 Pine Street
San Francisco, California 94111

Attention: Mr. Robert E. Gilbert

Dear Sirs:

CALIFORNIA FRANCHISE TAX RETURN
YEAR ENDED SEPTEMBER 30, 1974

In accordance with your instruction, we have prepared and enclose, in duplicate, California franchise tax return for the year ended September 30, 1974 for Barclays Bank International, Ltd. (BBI) — California Agency showing a tax of $26,671 and an unpaid balance of $691 which includes interest of $20.

The return has been prepared on the basis of reporting the worldwide income of Barclays Bank International, Ltd. and allocating a portion of that income to the BBI — California Agency according to the standard allocation formula for banks. As is prior returns, no detail of the worldwide income is provided in the returns. Upon examination, an agent could request a more detailed analysis of income and expense in arriving at the worldwide income of $139,279,400. Other items regarding the determination of the California Agency allocable income which should be noted are as follows:

1. The California Franchise Tax Board (FTB) may assert that pre-tax profits as outlined by the Barclays International Group consolidated profit and loss report should be used in determining worldwide net income rather than the "grossed-up" after-tax net income total which was provided by your London office and was utilized in the tax return calculations.

2. The resources factor was calculated without consideration of the following items as the worldwide information was not available:

a. The Reserve for loan losses was deducted in arriving at total resources although normal practice would be to exclude it.

b. The rent factor (8 × rents) was not included as an addition to total resources, although normal practice would be to include it.

In addition, the FTB may assert that property should be stated at original cost exclusive of depreciation, including fully depreciated property still in use. At present, the property used in the resources calculation is stated at book value which apparently includes some revaluation.

3. Personnel salaries have been charged against the BBI — California Agency operations as salaries of employees of Barclay. Accordingly, for purposes of the allocation factor calculations these salaries are included as "management fees" and no salaries are listed for the Agency.

CALIFORNIA DECLARATION OF ESTIMATED TAX
INCOME YEAR ENDING SEPTEMBER 30, 1974

We have reviewed the requirements of BBI — California Agency for paying California estimated tax payments for the year ending September 30, 1975 and have determined that estimated tax payments totaling $26,700 should be made. The revised deposits due are summarized on the enclosed instructions for payment.

Upon review and approval, the return should be filed in accordance with the instructions attached to the duplicate copy of the return.

Yours very truly,
PRICE WATERHOUSE & CO.

Enclosure—
Tax return

Price
Waterhouse & Co.

EXHIBIT TT

June 15, 1973

Barclays Bank International
111 Pine Street
San Francisco, California 94111

Attention: Mr. Robert Gilbert,
Controller
06915

Services rendered from June 16, 1972
through June 15, 1973 in connecion [sic] with:

The preparation of the California franchise tax return for the year ended September 30, 1972;

Preparation of the California declaration of estimated tax for the year ending September 30, 1973; and

Sundry tax and accounting assistance— $1,250

R.W. Vickrey:aw

June 18, 1974

Barclays Bank International, Ltd.
111 Pine Street
San Francisco, California 94111

Attention: Mr. Robert E. Gilbert

Services rendered through June 15, 1974 in connection with:

1. The preparation of the California franchise tax return for the Agency for the year ended September 30, 1973;
2. Review of required estimated California franchise tax payments for BBI for the year ending September 30, 1974;
3. Review and assistance with correspondence with the London home office and the Franchise Tax Board agent regarding combined unitary accounting; and
4. Sundry tax and accounting assistance— $900

J.E. Ullakko:aw

June 18, 1975

Barclays Bank International, Ltd.
111 Pine Street
San Francisco, California 94111

Attention: Mr. Robert Gilbert,
Controller

Tax and accounting services rendered from June 16, 1974 to June 15, 1975 in connection with the following:

Preparation of the California applications for extension of time within which to franchise tax returns for the year ended September 30, 1974;

Preparation of the California franchise tax return for the Agency for the year ended September 30, 1974;

Review of required estimated California franchise tax payments for BBI for the year ending September 30, 1975;

Consultation and assistance regarding the Franchise Tax Board's examination of BBI's franchise tax returns for the years ended September 30, 1969 through 1973;

$1,100

EXHIBIT UU

June 17, 1977

VT BUFFalow/mjp

Barclays Bank International, Ltd.
111 Pine Street
San Francisco, California 94111

Attention: Mr. Robert Gilbert

Tax and accounting services rendered from June 16, 1976 to June 15, 1977 in connection with the following:

Preparation of the California application for extension of time within which to file franchise tax returns for the year ended September 30, 1976;

Preparation of the California franchise tax return for the Agency for the year ended September 30, 1976;

Review of required estimated California franchise tax payments for BBI for the year ending September 30, 1977; and

Consultation regarding sundry tax and accounting matters—

$1,400

T.E.BISHOP/jcr

June 29, 1978
Invoice No. 1143-06915-015

Barclays Bank International, Ltd.
111 Pine Street
San Francisco, California 94111

Attention: Mr. Robert Gilbert,
Senior Vice President
and Controller

Tax and accounting services rendered from June 16, 1977 to June 15, 1978 in connection with the following:

Review of the California franchise tax return for the Agency for the year ended September 30, 1977

Review of required estimated California franchise tax payments for BBI for the year ending September 30, 1978;

Research and consultation regarding tax planning alternatives with respect to the boarding of loans in New York or in California; and

Consultation regarding sundry tax and accounting matters— $925

EXCERPTS OF GEORGE N. CARLSON

* * *

[p. 48] having been first duly sworn according to law, upon his oath testified as follows:

DIRECT EXAMINATION

BY MS. IRION:

[p. 62] Q. Mr. Carlson, during your tenure at Treasury, did you observe that there was an effort by the United States to further promote uniform rules to divide the income of multinational businesses among separate taxing jurisdictions?

A. Yes, I did.

* * *

Q. Did other nations try to do the same thing?

A. To—the same thing being to promote?

Q. The promote uniform rules—

A. Yes.

[p. 63] Q. —to divide the income?

A. Yes, they did.

* * *

Q. Are you aware of the reasons for this effort among the various nations?

A. I believe it—yes, I am.

Q. And what is that reason or reasons?

A. It's an understanding that in the world economy—and by that, I mean an economy that extends beyond the borders of any particular country—that generally speaking, the free flow of goods and services and investment income is a desirable objective in the sense that it increases overall economic welfare, as it were, and that free trade, for example, is a good thing.

Obviously, there are exceptions to this view in cases of embargoes on certain items for national security items or things like

that. But absent such exceptions, the economic rules ought to be such that there can be free [p. 64] movement of goods and investment capital, and a recognition as part of that that taxes can serve as barriers to trade or investment just as much as tariffs can, and that it's important to have common rules between two countries or among the countries so that those barriers can be reduced an perhaps eliminated.

Q. When you joined Treasury, did you learn that there was a United States policy to promote free trade?

A. Yes. That's, I think, fairly standard policy in most administrations, and President Reagan, for example, in this administration has proclaimed the virtues of free trade and free movement of international investment, and most of his predecessors have as well.

Q. Did you also see a policy of tax harmonization, Mr. Carlson?

A. Yes.

* * *

Q. (By Ms. Irion): Mr. Carlson, could you perhaps explain that?

A. I—by tax harmonization, I assume you mean that countries of the world talk to each other and meet and agree on rules of taxation that affect, for example, two countries. If investment is moving from one country to another country, how is the income from that investment going to be taxed?

[p. 65] Harmonization in the sense of a clear understanding of what the rules are, and also, harmonization in the sense that the rules are similar among the developed countries of the world.

* * *

[p. 68] Q. Now, when you were a member of the OECD Fiscal Affairs Transfer Pricing team, was there consideration of the use of the global method of taxation?

A. Yes, there was.

Q. And that, as you said earlier, is essentially the same as worldwide combined reporting?

A. That's correct.

* * *

[p. 69] Q. What was the reason for the discussion, Mr. Carlson?

A. The objective of the OECD Transfer Pricing group was to specify rules for valuing and transfer prices and also for determining the income of multinational corporations, and since worldwide combined reporting—or what the OECD called the global method—can or is viewed by some as an alternative to the separate accounting principle, the group felt that it was appropriate to consider whether the global method could be used as a method in arriving at income on a separate accounting basis, or if not, whether or not it would be an acceptable substitute for the separate accounting method.

Q. What were the results of those deliberations?

A. Based on the discussions at the OECD meetings, the committee members felt that the global method was not an acceptable method of determining the income of related corporations, multinational corporations, nor did it feel that it was consistent with the separate accounting or arm's-length method. They did not view it as a reasonable alternative to the separate accounting method either.

So that for all those reasons, the committee decided to reject global or worldwide combined reporting as a method of multinational taxation. I believe that finding was—or is reflected on the OECD's 1979 report.

* * *

[p. 75] Q. Now, Mr. Carlson, during your employment with Treasury, did you get complaints about the states' use of worldwide combined reporting?

A. The—yes, the Treasury received them, and I as a Treasury employee saw the complaints.

Q. All right. When —

A. Excuse me. I also received complaints directly. In the sense "received," was asked to meet with official from foreign governments who were with the economic attaches stationed as an economic officer in the embassy at Washington D.C., the economic or Treasury representatives of a particular country, and met with those people directly.

Q. When, to your knowledge, was the first time that Treasury started receiving complaints about the states' use of worldwide combined reporting?

A. In the early 1970s.

Q. Was this during the Nixon and Ford administrations?

A. Yes.

Q. Do you know the reasons why the complaints [p. 76] didn't start until then?

A. I believe that there was not a problem that was identified with respect to worldwide combined reporting. The—it wasn't until the early 1970s that it was—that combined reporting was applied on a worldwide basis, or at least applied on a worldwide basis with sufficient frequency and reach that it began to raise concern on the part of our foreign trading partners.

* * *

Q. How did the foreign government businesses and trade groups complain?

A. The—frequently, there would be a—a letter sent to Treasury officials, such as the Secretary of the Treasury or the Assistant Secretary for Tax Policy, from a foreign business group or from a trade association. Diplomatic notes from foreign countries were another vehicle of—those notes would be delivered either in mail or by person by the economic official attached to the embassy of that country in Washington.

[p. 77] Notes from the European Economic Community, which is made up of primarily Western European countries, were also received with a great deal of frequency. I believe between May of 1980 and September of 1983, the Treasury Department

received five separate notes from the European Community objecting strongly to the states' use of worldwide combined reporting.

The U.S. State Department would also forward to the Treasury Department representations and notes and objections that had been given to the State Department from departments from a foreign government.

So there were many, many ways in which the complaints were known. And then, as I indicate also, by personal visits where perhaps a member of the business community or trade association—excuse me, trade association or official of foreign governments stationed in Washington would object to the Treasury about this.

I also met, for example, with members of the British Parliament on this who were concerned about this.

Q. Now, these notes that you referred to, are they also referred to as "demarches"?

A. I believe that's the correct word, yes.

Q. Did you also have meetings with representatives from the government of Japan about complaints associated with the states' use of worldwide combined reporting?

A. Yes. The government of Japan, government of Canada, the government of the United Kingdom, the government of the Netherlands, all had meetings. I—I was personally [p. 78] involved with meetings of the officials of all of those governments.

Often, on more than one occasion on this issue, and there was a common theme or thrust to these meetings, and that was that these other countries were very concerned about the states' use of worldwide combined reporting and implored the administration to end it.

Q. While you were at Treasury, did the number of these complaints increase?

A. Yes.

Q. Did the intensity of these complaints increase?

A. Yes. The—as I mentioned, the—between March of 1980 and the fall of 1983, there were five separate notes from the European Community. Then in September of 1983, Prime Minister Trudeau from Canada sent the Treasury Department a letter strongly objecting to worldwide combined reporting which we found was—was found to be quite interesting in light of the fact that Canada, of course, has a federal system of government like we do. They have provinces which are equivalent to our states.

And the letter indicated an awareness of this, but also a feeling that worldwide combined reporting was creating serious international problems, and the prime minister—the letter was referred to the Treasury, although the letter itself was sent to the President of the United States to try to solve the problem.

Q. Mr. Carlson, to your knowledge, were heads of state discussing this issue?

[p. 79] A. Yes. The—this is an issue that—that after 1980, was raised at meetings that President Reagan would have with—after 1981, with the heads of state.

When the President would meet with Prime Minister Thatcher of Great Britain, for example, this was an issue that came up and was discussed. This is something that—that was talked about between both of them.

In the fall of, again, October or November, of 1983, not at the head of state level, but the financial minister level, financial administrative level, Secretary—I'm sorry, it was in the fall of 1985—Secretary Baker was going to meet with Mr. Takishida who is the prime—the finance minister of the government of Japan, and expected that the number one item on the issue — the number one issue on the agenda would be the global debt issues and debt problems with less-developed countries. But Mr. Takishida raised the worldwide combined reporting issue first and foremost—first and foremost with Secretary Baker.

Q. How are you aware of this, Mr. Carlson?

A. The—some of these events that I just described were mentioned in the press, in the financial press, and Business Week and that kind of thing.

Others, I was aware of through working in the government. And that would happen in the following way: When a meeting was to be held with a head of state or between the Secretary of the Treasury and his counterpart in another country, we would be asked to prepare briefing material on tax issues, and there was never in this period, '82, '83, [p. 80] '84, '85—never a meeting in which we were not asked to prepare something on the worldwide combined reporting issue, so the expectation was that it would come up frequently, and we would learn later the extent to which it was discussed because there would be some report back as to what transpired at the meeting.

Q. Mr. Carlson, based upon your work at Treasury before the mid 1970s, had state taxation ever been an international issue?

A. Not that I'm aware of.

Q. Were several pieces of federal legislation dealing with state taxes introduced into Congress in the late 1960's and early 1970s?

A. I believe the were.

Q. Now, did any of these bills deal solely with the issue of the combination of the overseas income of foreign multinational entities?

A. No. They — did not deal solely and exclusively with the combination of the income of a foreign-based multinational.

In fact, they were quite broad in the sense that they dealt with multistate tax issues in many cases that didn't touch directly on the foreign parent.

* * *

[p. 83] Q. (By Ms. Irion): Mr. Carlson, then, to your recollection, the 1970's was the first time that Treasury received and considered international complaints about state taxation?

A. Internationally that's correct, yes.

Q. What were the complaints that Treasury was referring about the states' use of worldwide combined reporting?

A. Well, first of all, the complaints were addressed specifically to worldwide combined reporting. I'm not aware of any foreign complaints on any other state tax issue. So that's — that was the issue that concerned them.

And they objected strongly to states use of worldwide combined reporting for a other [sic] number of reasons.

Q. What were those reasons?

A. They state—excuse me, the foreign governments felt that worldwide combined reporting was unreasonable because it gave rise to double taxation in the international arena; that it was inconsistent with the separate accounting or arm's-length standard that's reflected in the OECD transfer pricing report, and the OECD Model Treaty, and the network of bilateral tax treaties that the United States has with these countries.

[p. 84] They felt it was inconsistent with that. They felt that it was an administrative burden on corporations, foreign-based corporations, that had to comply with worldwide combined reporting. And generally, they indicated that in their view, it was creating a foreign policy problem in the sense that they viewed the states as following a foreign commerical [sic] policy which was divergent from that that was followed by the Federal Government.

Q. Did Treasury do an investigation of these complaints by foreign governments and foreign businesses?

A. Yes, they did.

Q. What did they do?

A. Well, they—it's somewhat similar to what I mentioned earlier about how policy decisions were reached. The complaints were investigated thoroughly and worldwide combined reporting, for example, was studied to identify precisely how it differed from the separate accounting standard. And given that it differed, what effect it had on a foreign corporation doing business in the United States.

And Treasury compared that method with the system of taxation both that the United States and the foreign countries

follow. And Treasury also looked at the extent to which it—this was—tried to determine the extent to which this diverged from the separate accounting standard.

MS. IRION: Your Honor, just for your information, the exhibit number that I was referring to with respect to the Task Force is 37-A, of the First Stipulation of Facts.

THE COURT: Thank you

[p. 85] Q. (By Ms. Irion): Mr. Carlson, did Treasury do any investigation of the complaints of foreign governments that use of the worldwide combined reporting system resulted in international multiple taxation?

A. Yes.

Q. And based upon Treasury's independent investigation, did Treasury find that the complaints were true?

A. Based on their—based on Treasury's study and analysis of the issues, a conclusion was reached—a conclusion was drawn, and that conclusion was that state use of worldwide combined reporting gave rise to an increased risk of double international taxation, and that accordingly, the complaints of the foreign governments on this point had a good deal of merit.

Q. What did Treasury base this upon?

A. What did Treasury base this conclusion on?

Q. This conclusion upon.

A. It was based on comparing the operation of the two methods, as I indicated earlier, under the separate accounting method, the taxable income of two corporations incorporated in different countries, even though they are related, even though one—by "related," I mean even though one may own the other or they may be owned by somebody else, the taxable income is determined separately. And then once that determination is made, a—the country in which the corporation is incorporated is allowed to apply its tax rules to that corporation's income to determine how much it's going [p. 86] to tax. Worldwide combined reporting, in contrast, as I indicated earlier, looks beyond a

single corporation to all corporations wherever incorporated, wherever they are doing business and taxes a uniform percentage or proportion of the income of all those corporations, and accordingly, it was inescapable that there was a risk of—increased risk of international double taxation because the income that was subject to tax under separate accounting in one country was also being taxed on a proportion of the formula basis under worldwide combined reporting.

Q. Did Treasury find that double tax was inevitable with the use of the system of worldwide combined reporting in conjunction with the international separate entity arm's length standard?

A. Yes, because they're two distinctly different methods and because not only the United States, but other countries, were taxing the income of corporations separately.

Another system superimposed on top of the separate accounting system that taxed a uniform percentage of the income of each and every corporation, wherever they are located, undeniably gave rise to risk of double taxation in the sense that the income that was subject to tax under separate accounting was also being subject to tax under worldwide combined reporting.

Q. Did treasury investigate the claims of administrative burden of foreign businesses?

A. Yes, it did.

Q. Based upon Treasury's investigation, did they [p. 87] find the claims of foreign multinationals that worldwide combined reporting was administratively burdensome to be true?

A. Yes, it did.

Q. Can you explain what Treasury's findings were based upon?

A. It was based on, again, a study of how worldwide combined reporting operates and a realization that for the purposes of being taxed on a worldwide combined reporting basis, a taxpayer would be required to report their income and business activities on a worldwide basis, assuming that it's all part of a unitary business, and this kind of a report, that is reporting the income

and business activities on a worldwide basis with respect to a foreign-based multinational doing business in the United States, is not required for either U.S. or Tax purposes nor is it required by any other country.

So that based on this conclusion that worldwide combined reporting required substantially more information than would be required even for U.S. Federal tax purposes, Treasury reached its conclusion that there was a compliance —that there was an administrative burden problem, and again, therefore, that the foreign complaints had merit.

Treasury, in particular, I believe, was troubled by the fact that it wasn't just a matter of collecting the information, but that in some cases, the corporation subject to tax may not even be able to get the information, may not [p. 88] have access to it. So it was asking for something that in some cases it was possible to provide and in other cases, impossible.

* * *

[p. 89] Q. Did Treasury investigate the claims of the foreign governments that the states' use of worldwide combined reporting was an irritant to international relations with the United States?

A. Yes, it did.

Q. And what was the result of that investigation?

A. The Treasury examined that complaint, and again, based on how worldwide—based on first analyzing exactly how worldwide combined reporting operates, what its effects are, comparing it with the separate accounting system, Treasury was able to arrive at a conclusion that worldwide combined reporting was markedly different from the separate accounting system followed by the United States and by the other countries of the world. Most pointedly in the sense that income of a foreign corporation not doing business in the United States is subject to tax under worldwide combined reporting, is not subject to tax under separate accounting, and that this was viewed by the foreign governments, by foreign trading partners, as a departure from international rules and, as evidenced by their objections, both

written and oral, was an irritant in our foreign commerce relations with these countries.

Q. Did the foreign governments complain that the states' use of worldwide combined reporting was directly [p. 90] affecting them as a governments?

A. Yes, they did.

Q. And how was that?

A. They—they were—as I've indicated, the foreign governments complained directly to the Treasury Department, and they made it clear that they had concerns of their own separate and distinct from those of businesses located in there United States. They were troubled by the fact that there could be a situation, such as was given rise by the states' use of worldwide combined reporting, where foreign business was subject to tax under different rules than the other countries of the world, and the United States followed. They found it—indicated to us that they found it somewhat embarrassing that—that another country should have that—excuse me, that a state could have tax rules that were different than the—different than the international rules.

So they were bothered from that standpoint. They were also bothered from the standpoint that they viewed worldwide combined reporting as giving rise to double taxation, and as I indicated before, based on a study, Treasury found merit to that complaint. And the significance of that for the foreign government, it was that—that when that income was taxed under worldwide combined reporting then it was less—less money left over for the foreign investor or for the foreign government. That is, that because of the higher tax imposed, for example, by the State of California that less money on foreign investment paid from the United [p. 91] States back to Britain, for example, would be available to be shared between the foreign government and the foreign business. So that they viewed this as something that they were very concerned about.

Q. Mr. Carlson, were you aware of whether representatives of these foreign governments met with officials of several states about the states' use of worldwide combined reporting?

A. Yes, I—yes, I am aware.

Q. All right. And did they do so?

A. Yes, they—yes, they did.

Members of the government of Japan and government of the United Kingdom met with state officials in California. This was something that—and in other states.

John Moore, for example, who is the—or was in July of 1985 the Financial Secretary to the British Treasury made a speech to the House of Commons in which he said—and this was just prior to a vote on some antiunitary legislation they were considering, and Mr. Moore said, "Before we vote on this, we should ask ourselves whether we've done everything possible to solve the problem."

And then he asked this question rhetorically, he said that "I believe we have talked to the Federal Government ad nauseum about it, but we also talked to the states," and this being July of 1985, Mr. Moore indicated that the officials from the British Government had been to North Dakota. Utah, Colorado and Florida and four separate times to California.

So that this was something that we were aware of was [p. 92] happening and was also an issue of some concern within the Treasury Department because we felt that foreign commercial relations are something that ought to be handled on a nation-to-nation basis and that—sub-federal units of government should not be involved in that.

Q. Why was there concern on the part of Treasury, Mr. Carlson?

A. Because of the feeling that the United States Government should be the party—that the Federal Government should be the party that deals with other countries, rather than other states.

* * *

Q. Now, Mr. Carlson, was the Federal Government having any difficulties because of the states' use of worldwide combined reporting?

A. The—yes.

Q. And what were those difficulties?

[p. 93] A. Well, it was receiving a great deal of, as I've indicated, complaints, representations, concerns from foreign governments, and the foreign governments were concerned that their share of international investment was being reduced by the states' use of worldwide combined reporting. They also felt that they were in an embarrassing position because their taxpayers were subject to rules that were different than the international standard, and accordingly, they—as I've indicated—complained directly to the Treasury Department, and that created problems for the Federal Government.

Q. Was the states' use of worldwide combined reporting interfering with the United States' policy?

A. Yes, I believe it was.

Q. And how was that?

A. Well, it was in the sense that there was a state tax system that, as I've explained, through the way it worked, and because of the fact that it's markedly different than separate accounting, which is what the United States and the other countries of the world use, that this was interfering with the kind of foreign commerce policy that we talked about earlier, establishing rules of harmonization and establishing rules that encourage relatively free flow of investment capital.

It was viewed—the looking—as foreign governments looked at us, they sometimes questioned whether we had one foreign policy or fifty-one different foreign policies. And this is something that was of great concern to both the Treasury Department and State Department because [p. 94] those branches—those portions of the Executive Branch feel that they are in charge of those responsibilities.

Q. Was the states' use of worldwide combined reporting embarrassing for the national government?

A. Yes, it was, in the sense that the foreign governments found it very difficult to understand how there could be a situation where a state could pursue a tax policy that had international ramifications, international ramifications that were at odds with

what the rules of the United States and the other countries followed.

This is something that time and again in meetings with foreign government officials I was asked the question, "How can you—how can this happen in your system of government?"

Q. Mr. Carlson, was the states' use of worldwide combined reporting interfering with the ability of the United States to negotiate bilateral treaties?

A. Yes, it was.

Q. And how was it doing that?

A. Well, again, because foreign governments were so sufficiently agitated over this problem that they were reluctant, and expressed their reluctance—the government of the Netherlands told us this. Germany told us this—to conclude a bilateral tax treaty unless they could have some assurance that the Federal Government could solve the problem.

And this gets back to the issue we were talking about a minute or two ago that the reason that the foreign [p. 95] governments felt that they—they in turn found it embarrassing or troublesome that there would be a situation where their businesses doing business in this country could be put at substantial tax risk because of a system that was different from what they used and what the United States used.

* * *

Q. Did Treasury have a policy concerning the use by the states of worldwide combined reporting as it applied to foreign multinational business?

A. By "foreign multinational business," again, you mean a corporation incorporated in another country outside the United States?

Q. Yes, Mr. Carlson.

A. Yes, Treasury did have such a policy.

Q. What was that policy?

A. The policy was, and is, that worldwide combined reporting ought not to be applied to foreign-based multinational corporations.

Q. And when was the first time that this policy was formulated, to your recollection, in Treasury?

A. That would be in connection with the United States-United Kingdom Income Tax Treaty which was signed December 31st, 1975. Although, since it was a treaty, of course, it had to be considered by the Senate, and the deliberations on that were not until two or three years later.

I'd put December 31st, 1975 as the initial time.

Q. And did the U.S.-U.K. Treaty as originally [p. 96] negotiated include a provision known as 9(4)?

A. Yes, it did.

Q. And what would that provision have done?

A. That was a provision that would have prohibited the states from applying worldwide combined reporting to a United Kingdom-based multinational corporation.

* * *

[p. 104] Q. What was the reason that the Treasury had drawn this distinction between the application of worldwide combined reporting as to foreign multinationals' businesses [p. 105] as opposed to domestic?

A. It was a judgment based on the analysis of the issue and the problem that—the problems that we have touched on of interference with foreign commercial policy, with treaty negotiations, of double taxation, with administrative burden, a potential of retaliation; all these things applied with full force to the case of the foreign-based multinational. It did not apply in all cases to the U.S.-based multinational. They were—some of these problems, in other words, were unique to the case of the foreign-based multinational, and accordingly, that was the reason for drawing this clear and unmistakable distinction in the testimony that worldwide combined reporting should be prohibited for foreign-based

multinationals and the same with respect to being less certain with respect to what the solution should be for U.S.-based multinationals.

* * *

[p. 167] Q. Mr. Carlson, at this time, did the Treasury believe as long as any state was using worldwide reporting that there would be a problem with the foreign trading partners?

A. This is in August of 1985?

Q. Yes, Mr. Carlson.

A. Yes.

* * *

[p. 193] Q. The difficulties caused for the United States were and always had been connected with the use of worldwide combined reporting as it applied to foreign-based multinationals; is that true Mr. Carlson?

A. In dealings with other countries, yes.

* * *

CROSS EXAMINATION

BY MR. MILAM:

[p. 214] Q. To the extent that a United States bilateral income tax treaty might differ from the OECD Model, the bilateral sets the rule of the United States; does it not?

A. That's correct, if the United States has a treaty with another country, and that describes and explains how income of the treaty partner earned in the United States will be taxed by the United States or how income earned by a U.S. resident or corporation in the country of the treaty partner would be taxed.

Q. Well, isn't it true that most United States [p. 215] treaties—income tax treaties affect only Federal taxes except for the purposes of nondiscrimination?

A. Again, we are talking income tax treaties, Mr. Milam?

Q. Income.

A. Yes. The U.S.—the income tax treaties which the United States has with other countries cover the U.S. federal income tax. They do not cover subfederal taxes.

* * *

[p. 226] Q. (By Mr. Milam): And later, isn't it true that the entire treaty was passed, except for 9(4), ratified by the U.S. Senate?

A. No, I don't believe that's exactly right Mr. Milam. The treaty was passed—ratified by the United States Senate with a vote of 82 to 5 with a reservation regarding the application of 9(4) to subfederal units of government.

The effect of the reservation was to merely reserve—merely exclude that provision from the treaty. So the 82 to 5 vote can only be interpreted as a vote on the treaty. The—a reservation is not a rejection of policy. It is merely excluding something from the treaty.

After all, there were many other issues that the treaty didn't cover, such as state and local sales taxes or estate and gift taxes, and the fact that these items were not [p. 227] included in the treaty certainly cannot be viewed as a rejection of administration policy in that area.

The effect of the reservation was simply to remove that provision from the treaty, but it was not a statement of congressional policy.

Q. Since the Senate reservation of 9(4) and ratification—subsequently, ratification of the U.S.-U.K. Treaty, has the Executive Branch of the United States negotiated another treaty with that same provision in it? That is, the provision as 9(4).

A. As applied to subfederal units of government, Mr. Milam?

Q. Yes. Yes.

A. No, it has not.

Q. And do you know the reason that the Executive Branch has not negotiated the treaty with that provision?

A. It's sought to resolve the issue in other ways; such as through judicial proceedings and the Working Group and Federal legislation. It sought to resolve it through other vehicles.

* * *

[p. 236] Q. Did you explain to them the nature of our Federal governmental system?

A. Yes, I did. The nature of our Federal governmental system was an issue that came up time and time again in discussions with foreign trading partners because [p. 237] they had a difficult time understanding how a state could have its own foreign policy.

Q. And what did you tell them with respect to our Federal system?

A. That individual states had the right to impose certain taxes absent creating major problems, and that if a significant problem had been created and we, the administration, agreed with it, or the Executive Branch agreed with it after analysis, that we would see what could be done about it.

But, as with the Working Group recommendations, if it's going to be adopted at the state level, that's up to the state legislature and the governor in a particular state.

Q. And what did you tell them Federal Government could do about it?

A. About encouraging a change of state law, for example?

Q. About changing state law.

A. We indicated that we could encourage the states to change their state law, as we had all along, and that if that did not happen, that the administration was prepared to recommend Federal legislation to restrict state law as far as applying worldwide combined reporting to foreign-based corporations.

* * *

[p. 244] Q. To your knowledge, is California's use of the worldwide combined reporting method prohibited by the U.S.-U.K. Treaty?

A. It's not prohibited by the treaty. It's not covered by the treaty.

It's not covered by the treaty; therefore, it's not prohibited by the treaty.

Q. To your knowledge, is California required to use separate accounting by the U.S.-U.K. Treaty?

A. Because the worldwide combined reporting is not covered by the U.S.-U.K. Treaty, there could be no requirement to use separate accounting, which of course, is the international-accepted alternative to worldwide combined reporting.

* * *

[p. 276] Q. In the Working Group Report and the recommendation of the Task Force, wasn't there acceptance of the fact that in certain circumstances the states could use worldwide combination?

A. I believe that's correct.

Q. And under what circumstances could they use worldwide combination?

A. That, of course, would be an exception to the basic recommendation of the Working Group. I believe one exception was that if a spread sheet or disclosure document had not been filed with the Internal Revenue Service—this was a document that was related to the second Working Group recommendation—that in that case, if the—in other words, if the taxpayer had not lived up to recommendation 2 in the Working Group, then in that case, the state would not be bound by—could apply worldwide combination.

Q. Was it basically a failure to provide information? Is that what you are talking about?

A. I believe that it referred to the information that was going to be provided or provided for under the second recommendation of the Working Group, not providing that specific information.

EXCERPT DEPOSITION READ INTO THE RECORD OF DONALD M. MARNACH

* * *

[p. 351] "Q. So in order to make the adjustments, if you are a foreign parent company with affiliates in several countries, would you have to make depreciation schedules for assets located or owned by the affiliates of those various countries according to U.S. or California schedules?

A. If you wish an adjustment to be made, other than to your book depreciation, yes, and that would—I would think would depend on whether or not you felt the adjustment was material."

[p. 352] "Q. If a U.K. parent company wished to obtain—take advantage of the depreciation allowances under the California unitary return, they would have to either develop schedules for the devaluation and depreciation under California [p. 353] and U.S. accounting purposes from all of its affiliates or have that information be furnished to them; would they not?

A. For California purposes; not necessarily need the United States—"

* * *

"Q. All right. But they would need schedules for California for each of its affiliates all around the world; is that correct?

A. If they chose to have an adjustment to their book depreciation, yes."

* * *

"Q. So, if they operated in 70 countries around the world, they would have to have depreciation schedules on the California basis for essentially 70 countries; is that true?

A. If they chose to have the depreciation adjustment, assuming that they deemed that the depreciation was a material item to worry about, yes."

* * *

[p. 354] "Q. Okay. I think I understand with respect to the bad-debt reserve. If a foreign parent company with foreign affiliates in over 70 countries was to take advantage of the California bad debt reserve, what information would they need to do that?

A. Well, they need to know their loan base, which they had—I would expect have for consolidated loan purposes that shows the amount of their receivables."

* * *

"Q. And then they would have to know where those—how those rules differed from the bad debt reserve rules in the [p. 355] country in which the affiliates were operating as well as the parent company; is that true?

A. Yes."

* * *

"Q. All right. Now, once they have that information, what do they do with it if they really want to take advantage of California bad debt reserve rules?

A. They establish—well, their financial statements essentially are going to have to show their amount of receivables. They would have to know how much was—were charged off over a number of years."

* * *

"Q. Okay. And that's with respect to loans made by affiliates in each of the 70 countries; is that correct?

A. Yes."

* * *

[p. 356] "Q. With respect to adjustment—LIFO adjustment in particular industries, again, would adjustments have to be made from the accounting conventions used in the host country—the country in which an affiliate is operating—to the conventions used in the United States or California in order to take advantage of the LIFO rules, if applicable?

A. Yes."

* * *

"Q. Okay. So that would mean preparation of schedules in accordance with California rules by each of the affiliates operating around the world; is that correct?

A. Yes."

* * *

"Q. So, if you had affiliates operating in over 70 countries, they would need to prepare 70 different schedules according to the California method; is that correct?

A. If they did not use LIFO for book [p. 357] purposes and they chose to get the benefits of LIFO for California tax purposes, yes."

* * *

[p. 358] Question: "Well, assuming that the affiliates of a unitary business did not use LIFO, did not depreciate assets, didn't have reserves computed into the California method, and they didn't typically convey this information to their parents, and if they wanted to take advantage of the California rules, they would essentially have to have accounting systems set up under California rules and regulations or

make adjustments to their rules under the California method in order to take advantage of California [p. 359] Unitary regulations; isn't that true?

A. They would have to either—either set up schedules or develop a system that would satisfy the auditor or the administrative relief procedures that they are entitled to adjustment, yes."

EXCERPT DEPOSITION READ INTO THE RECORD OF HOWARD G. VANDEBERG

* * *

[p. 365] "Q. So that there was expansion of investment by United States companies in the foreign markets, and conversely, by foreign businesses in the United States market, between '75 and—in the mid-70's?

[p. 366] A. Yes. Companies were going from a national concept to multinational concept, becoming world companies rather than national companies."

* * *

"Q. In this period, there began to be some concerns expressed by certain taxpayers with respect to the feasibility of complying with California unitary on a worldwide basis, certain complaints that were raised at this point time; isn't that true?

A. Yes."

* * *

"Q. One of the reasons that you were hearing the complaints at this point in time—when the California unitary theory had been in practice for several years—was that this was really the first period of time that the unitary concept had been expanded offshore and basically because the operation had increased?

A. I think it was probably one of the [p. 367] first times they became exposed to this particular requirement that they

report on a worldwide basis because they expanded within this country."

EXCERPTS OF WILLIAM MICHAEL JOHN GRYLLS

* * *

[p. 399] having been first duly sworn according to law, upon his oath testified as follows:

DIRECT EXAMINATION

BY MR. JORDAN:

[p. 410] Q. (By Mr. Jordan): Let me start all over.

In evidence in this case, and for your information, it's Exhibit 81, is the U.K. brief filed as a friend of the court in this very litigation.

In that statement—in that brief, the United Kingdom has stated that "The application of the California method of taxing income of foreign multinational corporations doing business in the United States offends the major trading partners of the United States," and that's at Page 7 and 8 of the brief.

My question is: Mr. Grylls, did your investigation as a member of this committee and as a member of Parliament and your discussions with these corporations, these major British corporations, substantiate with you what I read to you from the U.K. brief?

A. It did.

Q. Can you explain what you found out as a member of this committee in relationship to these complaints of these British corporations?

A. Yes. We did not just accept their word that they were unhappy with the form of taxation that we are discussing superficially. We investigated it very carefully with them, and to that extent, it was firsthand knowledge rather than hearsay.

[p. 411] And we have many people, your Honor, who come to legislators all over the world with complaints about one thing or any, and you do somehow have to try and learn what is genuine and what is not genuine, and I was perfectly satisfied, as indeed were some 250 of my colleagues, that this is a very genuine and real complaint that they had about this form of taxation, and it was not a superficial complaint. It was very much something that was getting in the way of international trade and causing great problems of aggravation and aggravation in their investment business. So it was very real, the problem.

* * *

[p. 413] Q. (By Mr. Jordan): Now, what did you do, Mr. Grylls, in response to these complaints?

A. We talked with the Government to see what actions the Government could take in an executive way to apply pressure on the United States' administration in Washington to see whether this form of taxation could be changed, and it was that pressure we kept up through many years. Over ten years now.

* * *

[p. 417] Q. (By Mr. Jordan): I don't know where—you were explaining the procedure that is used in Parliament for the acceptance of treaties with other countries. Could you continue with that?

A. Yes. We had a debate which formed the acceptance of this treaty, and during that debate, the Rt. Honorable Peter Rees, R-e-e-s, who was the Minister of the State of the Treasury explained the situation over the clause 9(4) and what happened in the United States Senate, and said that, nevertheless, despite that, the British Government will continue to work in every way it could to ensure that the worldwide combined reporting system of the Unitary taxation would be abolished, and therefore, British companies would be protected.

Now, we took that on trust at that time, and that trust was based not only on the opinion of the Brutish Government, but on assurances from the United States that they too saw it as a serious issue.

Q. You were personally assured that by representatives of the United States?

A. On a number of occasions over the years, yes.

EXCERPTS OF H. BARRY BERLIN

* * *

[p. 493] having been fist duly sworn according to law, upon his oath testified as follows:

DIRECT EXAMINATION

BY MS. IRION:

[p. 564] Q. (By Ms. Irion): Mr. Berlin, what was that determination as to the sufficiency of the information collected centrally for purposes of filing a California worldwide combined report?

* * *

THE WITNESS: There was insufficient information collected centrally for 1977 to file a worldwide combined report for California.

Q. (By Ms. Irion): And just for purposes of clarification, when you did your review in 1984, was there information centrally collected which was sufficient to prepare a California worldwide combined report?

A. In 1984, there also was not sufficient information collected centrally to permit the proper filing of a worldwide combined report for California.

Q. What was the reason for that, Mr. Berlin?

A. The reason that there was insufficient information is because, as I discussed yesterday, the need to make appropriate tax accounting adjustments to financial statement income, and in order to make those adjustments, you [p. 565] have to access to a

detailed level of information and not a summary level of information.

The information that is collected centrally for the Barclays Bank Limited Group did not have a sufficient level of detail to permit an accurate calculation of tax accounting adjustments, and in many cases, alternative calculations where there could be a benefit available to a taxpayer, it was not available at the central location, and would have been— in order to obtain that information, would have required contacting each of the locations where the detailed information resided.

* * *

[p. 578] Q. You were referring to the type of source information which would be necessary to file a worldwide combined report.

Would you need this detailed source information to take advantage of the benefits of the federal and the California tax rules?

A. You would need this information to take advantage of the benefits permitted under the California tax rules which incorporate the federal tax rules.

You don't need them when you file a federal return because a federal return does not require you to accumulate information for business activities of corporations that do not do business in the United States.

Q. So really, it would only be for purposes of obtaining the benefits of the tax rules of California?

A. That's correct.

Q. Except for the purpose of filing a California worldwide combined report, does the Barclays Group have any [p. 579] reason to collect the type of information that you've been referring to?

A. There is no reason to collect the information that I've discussed other than to file a California worldwide combined report.

* * *

VOIR DIRE EXAMINATION

BY MR. MILAM:

[p. 618] Q. (By Mr. Milam): Isn't it true that Price Waterhouse prepared the 1977 California tax return for Barclays Bank International Limited?

A. I believe that's correct.

Q. And isn't it true that that return was prepared on a worldwide basis including—excuse me —

MR. MILAM: May I approach the witness, your Honor?

THE COURT: Of course.

Q. (By Mr. Milam):—including all of Barclays Bank International Limited's international subsidiaries and branches?

A. There was information in the return that indicates it related to that group, but in my view was not [p. 619] information that would have been correct under the California regulations.

Q. That was submitted, though, to the California Franchise Tax Board by Price Waterhouse; was it not?

A. It was.

Q. And it was on a worldwide basis, was it not, including the subsidiaries and Swaziland and all the other Barclays Bank International Limited subsidiaries and branches?

A. It included information relating to Barclays Bank International Limited and its subsidiaries, but no other members of the Barclays Bank Limited Group.

THE COURT: Pardon me. Did I understand the answer? Was it "Included the BBI subsidiaries and branches, but not the BBL"?

THE WITNESS: Right.

THE COURT: The others subsidiaries and branches?

THE WITNESS: That's correct, your Honor.

Q. (By Mr. Milam): I don't want to make another mark on this thing. It would be this, would it not, Mr. Berlin?

A. If I knew where your finger was going to go.

Q. If I were "Plastic man."

THE COURT: Well, for the record, what you've described is the grouping under the heading Barclays Bank International Limited.

MR. MILAM: Yes.

THE COURT: On Exhibit 3.

[p. 620] MR. MILAM: Yes.

THE WITNESS: That's correct.

Q. (By Mr. Milam): Did you ask Price Waterhouse what it cost them to prepare that return for the California Franchise Tax Board?

MS. IRION: Your Honor, this is really getting into the realm of cross-examination.

THE COURT: No, it isn't. Overruled.

THE WITNESS: No.

* * *

[p. 672] Q. In developing this cost, you did not consider the use of reasonable approximations in determining what information was necessary to file a worldwide report; did you?

A. I did not consider reasonable costs. I considered the requirements of the regulations.

Q. Did you mean "reasonable approximations"?

A. Reasonable approximations.

* * *

DIRECT EXAMINATION

BY MRS. IRION:

[p. 694] Q. In your cost study, Mr. Berlin, is there a reason that you did not recommend that the Barclays Group establish a system to collect information which is acceptable only in the discretion of a taxing authority?

A. Yes. Such a system is unworkable from the standpoint of knowing what needs to be provided. If you leave yourself open to a system that's based on facts and circumstances, until you collect those facts and circumstances, you don't know what's reasonable. And in any case, you cannot predict what is going to be acceptable to a taxing jurisdiction.

The approach that has been taken in designing a system is to review what specific information is requested as part of the preparation of the tax return for that jurisdiction and obtain—and design a system that obtains that information.

To try to design a system that obtains three quarters of that information is going to leave you open to an adjustment for tax, open for discussion, and lead to uncertainty in your tax filings. And what you want to try to establish in any tax filing is a high level of certainty that your tax filing is within the requirements of that jurisdiction and is going to be accepted by that jurisdiction as filed.

Q. Is there a reason, Mr. Berlin, that you did not consider the cost for P.W. to prepare a California return in preparing your cost estimate?

A. Yes, there was a reason.

[p. 695] Q. What was that reason, please?

A. First off, P.W. did not provide a—or prepare a worldwide combined report or the Barclays Group.

Second, their—their cost is merely the cost of their efforts in preparing the tax return. What this schedule provides is the cost of all efforts involved in preparing a worldwide combined report.

If P.W. were to come to Barclays and say, "We need a number for worldwide income," what happens is Barclays then, to properly respond, still has to go through this cost internally and come back to Price Waterhouse and say, "We have calculated income according to California rules and regulations," and so the costs—there have been costs incurred at Barclays that P.W. would never show on their bills.

EXCERPT DEPOSITION READ INTO THE RECORD OF JOHN K. SHANK

* * *

[856] "Q. Is it your opinion, Professor Shank, that a taxpayer need not comply with the full letter of the law as stated in the California Revenue and Taxation Code and in the regulations?

A. That is my opinion, yes."

* * *

"Q. Did you understand my question?

A. Yeah. Full letter of the law, I understand what that means, in my opinion.

Q. What does that mean to you?

A. I don't—I don't know how to quite get at it. There is a concept to the tax, okay? The concept of the tax says you earn a certain amount of money worldwide, and California is entitled to tax a proportion of that. And the [p. 857] proportion is based on a weighted aggregate of property—of a property factor, a sales factor and a payroll factor.

Now, full letter of the law involves, you know, a very long circuitous, detailed summary, some set of adjustments, and I don't believe that any corporation in the world— personal, professional opinion—fully qualifies, you know, with any legislation like that."

MS. IRION: I think it's "complies."

* * *

"A. Fully complies, you know, with any legislation like that. It's always a question of materiality, estimates, judgement. How far do we have to go so that we are in substantial compliance? Where that becomes a definition, that's worked out between the taxpayer and the taxing authority."

* * *

[p. 860] "Q. Let's talk about your 25 years of experience. Do you know any other system in the world that requires a subsidiary in order to file its tax return to know the income of the combined unitary group?

A. You're asking me the specifics of the California law?

Q. I'm asking you—

A. No, I don't know of one.

Q. Do you know of any other system in the world, taxing system, which requires a subsidiary of a foreign parent to request information from the parent in order to file its separate return?

A. No.

Q. Do you know of any other system in the world that requires a subsidiary to request information from a foreign parent about property or payroll or sales of other entities [p. 861] in order to file its return?

A. No."

* * *

[p. 862] Q. Do you know—were you informed by Mr. Miller that there was any foreign-based taxpayer that could file its California worldwide combined return under the methodology set forth in the California Revenue and Taxation Code and 25137 regs that you reviewed for foreign-combined operations?

A. Yeah. The answer is no.

[p. 863] Q. Okay.

A. I don't think anybody in the world has an accounting system—certainly not a foreign-based multinational—that would permit them from their existing accounting system to produce a return that was in full technical compliance with the regs."

* * *

"Q. When you say certainly not a foreign-based multinational, why is that?

A. Because for a foreign-based multinational, you get two additional sets of complications which are not there for a U.S.-based multinational.

Q. And what are they?

A. First is the difference in the—in accounting standards. A U.S.-based multinational has all its accounting systems designed to produce financial statements that wind up in accordance with U.S. generally-accepted accounting principles.

A. U.K. based multinational, for example, would have its accounting systems set up to produce financial statements in the end that [p. 864] are in accordance with the U.K. accounting standards, and those are different.

So that a foreign-based multinational has one major set of problems adjusting to U.S.-based—U.S.-based accounting standards, that's one.

Q. And are there significant differences in accounting standards, generally-accepted accounting standards between the United States and other countries?

A. Yes.

Q. And what is the second factor that you base that upon?

A. The second factor is the currency translation. The foreign-based multinational has its accounting system set up to generate financial statements in its home currency. And that is certainly not the U.S. dollar. So for them to comply

with U.S. tax legislation, they have to then create financial statements in U.S. dollars which is another whole big set of problems.

Q. And in your mind, would that factor make it more difficult for a foreign-based company using existing accounting system to attempt to comply with the California statute and legislation?

A. Yes. And going beyond that, it [p. 865] would make it so difficult that I don't believe it would be possible for—I don't believe any foreign-based multinational would have an accounting system that would enable it to produce a tax return in full technical compliance with California law."

* * *

"Q. Are the accounting systems set up for domestic-based multinational corporations sufficient, in your opinion, to comply with the statutes and regulations for filing a combined report?

A. There are still two major problems left. The answer is no because of two major problems that are still left even for the domestic multinational.

One of which—I'm sorry, do you want me to tell you the two?

Q. Yes, please, I would appreciate it.

A. One is the difference between accounting records for management purposes and public reporting purposes versus accounting [p. 866] standards for federal tax purposes. Those are different.

And the second even beyond that are the different tax laws, plural, for individual states versus the federal tax laws. There are differences there."

* * *

[p. 867] "Q. Can Barclays Bank and Barclays Group comply with the procedure set forth in 25137-6 Methodology 1?

A. Okay. The answer—could they, yes. At a reasonable cost, no."

* * *

[p. 868] "Q. Let me ask you the same question. Could Barclays Bank the Barclays Group comply with the methodology set forth in Method 2 of the 25137-6 regulations at a reasonable cost?

A. Using approximations, yes."

* * *

"Q. Excluding the use of reasonable approximations?

A. Yeah. Then the answer is no they could not.

Q. Okay.

A. At a reasonable cost.

Q. At a reasonable cost. And that is even considering the concept of materiality?

[p. 869] A. That is right."

* * *

Would your answer be the same for every other foreign-based multinational company?

A. Yes.

Q. Would your answer also be the same with respect to domestic multinational companies?

A. Yes."

* * *

[p. 870] "Q. Incidentally, if the Franchise Tax Board does not accept the reasonable approximations offered by a taxpayer, what's the penalty to the taxpayer?

A. I have no idea. I mean, essentially the penalty is terribly onerous. That means you have to produce. You have to go well beyond what is reasonable to comply with the return. I don't know what the legislative relief would be.

* * *

EXCERPTS OF BERNARD L. CALDWELL

* * *

[p. 904] having been duly sworn according to law, upon his oath testified as follows:

DIRECT EXAMINATION

BY MR. JORDAN:

[p. 910] Q. These regulations in Exhibit 12 before you [p. 911] require a foreign—that is, a non-U.S. multinational corporation to report income for tax basis on the worldwide unitary method; is that correct?

A. Yes.

Q. Now, in your experience and your understanding of the regulations, do those regulations impose upon a foreign multinational corporation any step or steps not required of domestic multinational corporations?

A. Yes.

Q. And to comply, does the foreign multinational corporation have to compile data which is unnecessary for any other purpose?

A. My opinion, to properly file the unitary return, there are records that will be required to be maintained which are only for the purposes of filing that return.

Q. And does this compilation of extra data constitute a burden to such corporation?

A. It can, yes.

Q. And could you characterize that as heavy or light or —

A. In many instances, it could be rather expensive.

Q. And would an expansion of that opinion of yours depend upon the nature of the corporation, the countries of operations, branches, and that sort of thing?

A. Certainly. To the extent that there are numerous non-U.S. subsidiaries located in more than one [p. 912] country or numerous countries, the greater the number of corporations and the more expansive throughout the world their operations are, the more difficult and expensive it is to accumulate the data necessary to file the return.

* * *

[p. 932] Q. All right. Now, Mr. Caldwell, it's been stated as part of the evidence in this case by an expert for the Franchise Tax Board that—and I quote: "I don't believe any foreign-based multinational would have an accounting system that would enable it to produce a tax return in full compliance with the California law."

Do you—in your experience, have you observed or do you have an opinion that this is a true statement?

THE COURT:	Excuse me. From what did you just read?
MR. JORDAN:	I read from Exhibit 69, which is the excerpt—
THE COURT:	All right.
MR. JORDAN:	—of Shank's deposition.
THE WITNESS:	I would agree with that statement.

Q. (By Mr. Jordan): Now, in the event that a foreign-based multinational does not have an accounting [p. 933] system that would enable it to comply with the California Revenue and Taxation Code, is there any other method or procedure outlined in the regulations that would help such a taxpayer out?

A. In my practice of taxes, I have not found that there is another method that would help taxpayers.

The regulations do refer to a method which can be requested that would apply some general guidelines to the determination of

what the tax base is, but in my experience, I have not seen that operate either accurately or consistently.

Q. Well, let me be specific and ask you about the portion of the regulations that state that only material adjustments need to be made to comply.

Are you familiar with that section?

A. Yes.

* * *

[p. 934] Q. Well, let me just go right to that then. Is it—can a taxpayer, foreign multinational taxpayer, comply with the regulations relating to the California franchise tax by simply making adjustments to published financial information?

A. I don't believe that that would constitute a proper filing, merely to take the consolidated financial statements and use those for the purposes of filing a franchise tax return.

And I say that based upon my experience with revenue examining agents of the Franchise Tax Board and their requirement that there be an analysis made of specific accounts and substantial adjustment made to that reported income.

Q. Now, by published information, I am referring to such things as reports to shareholders—

A. Reports to shareholders, reports to regulatory authorities.

Q. Such as the SEC?

[p. 935] A. The SEC, or banks, to the Controller of the Currency, or to the FDIC.

Q. Now, would a taxpayer be able to make material—make only material adjustments to its financial data without knowing the entire financial situation of the corporation?

A. That is the point, unless you have accounting information which will permit you to measure the difference between the income or expense reported for financial statement purposes and the amount of income or expense that the Franchise Tax Board regulations require, you never know if it is material, and they would not know if it is material.

Therefore, my opinion is you must have records that will produce how much that difference is. And that then permits you to file a correct return with the Franchise Tax Board.

Q. So putting it another way: If a foreign-based multinational corporation did not have an accounting system in place that would enable it to comply with the California method, it would not be able to tell the Franchise Tax Board which adjustments are material and which adjustments are not material; is that correct?

A. That's correct.

* * *

[p. 936] Q. Just paragraph 1.

A. "In computing the income and any of the factors required for a combined report, the Franchise Tax Board shall consider the effort and expense required to obtain the necessary information.

"In appropriate cases, such as when the necessary data cannot be developed from financial records maintained in the regular course of business, the Franchise [p. 937] Tax Board may accept reasonable approximations."

Q. Now, is this a method, in your opinion, that would allow a foreign-based multinational corporation to comply with the California income tax regulation?

A. I have the same problem as previously discussed when we were talking about going from financial statement income to taxable income. Without a system of accounts or records in order to determine the amount of any particular difference between a detailed reporting and a reporting on some other basis, the facts are not known, and therefore, you would be unable to file on that method.

Q. Now, Mr. Caldwell, is there any provision in this section of the California income tax regulation or any other regulation in the State of California that would enable you as a tax preparer, or give you any guidelines as a tax preparer to help you in determining what are reasonable approximations or what are material adjustments to the financial data?

A. I have been unable to find any definition of what is reasonable approximation or—

Q. In—am I correct to state, then, this would depend upon the whim of the particular auditor that is handling your tax return with the Franchise Tax Board?

A. In practice, the auditors request detailed information with respect to specific items of income or expense or overall methods of accounting for them to judge whether it is material.

Unless you have the records, you are unable to [p. 938] provide the information they request, and therefore, you subject yourself to an unknown tax base, which I believe is unacceptable when you are preparing tax returns for—for clients.

Q. Is this unknown tax base—this would be a liability on the part of the corporation; wouldn't it?

A. Yes.

Q. And is there any way that you as the auditor for the company or the counsel for the company to be able to determine in advance what this tax liability would be to make provision for—

A. No, you cannot determine what the expense would be unless you have the information that would tell you what the difference would be in the taxable income. That requires the records again.

You have no basis of comparison unless you have determined what the differences are in accounting methods or in reporting. Kept records, then, that would permit you to measure what that difference is between the financial statement income or expense and what California's regulations require as the proper recording for their purposes of income or expense.

Q. Now, in subsection 2 of (e)—you have just read subsection 1. But in subsection 2, there is a provision that the taxpayer can request advance determination of the liability from the legal division of the Franchise Tax Board.

Does that help you out in determining what the tax liability of a foreign multinational corporation would be?

[p. 939] A. In my experience, it hasn't.

Q. It has not?

A. It has not. And the reason is that it states that you must file the facts and circumstances that cause you to request this advance determination, and since—if you have not maintained the records, you have no way to calculate the difference. And that is the critical fact.

You do not know—you do not have the information necessary to file the request unless you have maintained the records, and then that causes you to incur that cost because you must have the records in order to produce the filing.

Q. So neither the material adjustment section, nor the reasonable approximation section, nor the advance determination section, contain any guidelines to you as a CPA on behalf of your clients to determine what the Franchise Tax Board liability would be?

A. That is correct. There is no other information contained other than those we have discussed. They are based upon the facts of the specific taxpayer, and the fact in this case has to be the materiality under that section or under a subsequent section where we are talking about facts and circumstances and the costs.

You must have a position for them to measure it and that is the dollars. Without separate accounting records to determine that, you do not have the facts.

Q. So without any rules or guidelines under those three provisions, the system as applied to a foreign-based taxpayer would be an arbitrary one?

[P. 940] A. It is an unknown one.

Q. Does that make it arbitrary?

A. It becomes arbitrary if it's unknown.

* * *

[P. 946] Q. So the total annual cost, in your opinion, to [p. 947] comply with the California Revenue and Taxation Code would be $2 million?

A. That is correct. There would be an initial set-up of systems, investment of approximately 6.4 million.

Thereafter, an annual burden of $2 million. So the first year, you would be looking at $8.4 million, and in subsequent years, two million annually.

Q So the figure you have for $8,400,000 for total compliance costs would be for the first year?

A. Compliance and set-up for the first year would be 8.4 million.

* * *

[p. 955] Q. You did not take a detailed look at the Barclays' accounting system for the purposes of this cost of compliance; did you?

A. No.

* * *

CROSS EXAMINATION

BY MR. MILAM:

[p. 969] Q. Were you ever informed by anybody at Barclays or Barclays' attorneys in this case that BBI, the—a first-tier subsidiary of BBL, had filed on a partial worldwide basis in 1977 with the State of California?

A. Yes.

* * *

[p. 970] Q. Well, you didn't make any effort to determine what it cost Barclays to file that report, did you?

A. I did not.

Q. In developing a cost to comply with California worldwide reporting requirements, wouldn't it be important to know what Barclays' costs in partially fulfilling those requirements had been?

A. It was a partial worldwide combination, not a complete combination, and based upon my questions and the review of the accounts, it was clear that they did not have the information from

separate accounts that would produce all of the adjustments which I believe would be necessary to file an accurate franchise tax return.

Therefore, I did not think that those costs would have that much value to me in making a determination of what would need to be incurred to do it correctly.

* * *

[p. 1027] THE COURT: I just have one question, Mr. Caldwell.

You have addressed yourself to the difficulties of the foreign parent corporation with foreign subsidiaries complying with California's unitary tax scheme for income taxes.

How would you compare the plight of that type corporation with the plight of, let's say, a New York corporation which equally has foreign subsidiaries, an equal number let's say, and does business throughout the world [p. 1028] through owned subsidiaries, wholly-owned, and some partially-owned and which does business in California to some extent, so as to become subject to the unitary tax law.

Would the effect be the same?

THE WITNESS: It would be more difficult for the foreign multinational, and I have two or three reasons for that.

THE COURT: Will you articulate those for me, please?

THE WITNESS: Yes. One reason, as we talked about, the U.S. corporation immediately is on a U.S. generally-accepted accounting basis under U.S. standards. So you have a better beginning point.

Secondly, I said in the analysis that we had on the two charts that there is some information that is required by the U.S. multinational which is not required by the foreign multinational.

One of the specific areas is that the Internal Revenue Service requires U.S. multinationals to provide information in many cases on a U.S. tax concept basis in and summary form for all of the foreign subsidiaries.

So since that is a requirement under the Internal Revenue Code, a U.S. multinational corporation starts with the U.S. taxable income and then merely makes California franchise tax adjustments rather than going back and making all of the adjustments. And there's just an abundant number of adjustments that would be included under IRS rules. It is much easier to go from there to California than it is to go from foreign [p. 1029] GAAP to California.

THE COURT: Well, however, the domestic New York corporation, let's say, still has to deal with the problems attendant upon its totally-foreign subsidiaries and the laws with which they operate in the foreign countries. Aren't those the same—

THE WITNESS: Yes.

THE COURT: —as what would be involved with this foreign-based—

THE WITNESS: Yes.

THE COURT: —multinational?

THE WITNESS: My point would be going from that worldwide income, which is as difficult for the New York corporation that has foreign subsidiaries as it is for a U.K. company with a foreign subsidiary, to the California taxable income base—and because of the generally-accepted accounting required in the U.S. and the fact that there are analyses and schedules prepared on an information basis for the foreign subsidiaries of that U.S. company—your beginning point is much closer to the taxable income that California has than the foreign multinational.

THE COURT: And that is due to the fact that the IRS has requirements that are applicable to a domestic corporation of any state incorporated and headquarters in any state of the United States affecting its foreign subsidiaries business and their—

THE WITNESS: Required information reporting.

* * *

EXCERPTS OF JOHN DEREK TAYLOR-THOMPSON

* * *

[p. 1033] having been first duly sworn according to law, upon his oath testified as follows:

DIRECT EXAMINATION

BY MS. IRION:

[p. 1040] Q. Now, in the United Kingdom treaties which you negotiated or were aware of, did both the treaty partners come to the negotiating table with the understanding that the separate entity arm's-length basis was the method upon which the income of multinational businesses operating across national boundaries was to be divided?

A. Yes.

Q. Now, was this true for both developed countries and developing countries?

A. Yes.

Q. At this time, the United Kingdom had treaties with developing countries?

A. Yes.

* * *

[p. 1041] Q. In the United Kingdom treaties which you negotiated or were aware of, was there any other basis upon which the income of multinational businesses operating across national boundaries was divided between the U.K. and its treaty partners?

A. No, I'm not aware of any other method than the one I've described.

Q. And this was true even as early as the late 1950s and early 1960s?

A. Yes.

* * *

[p. 1060] Q. And what is the problem with unrelieved double taxation, Mr. Taylor Thompson?

A. Well, the problem there is that the same profits or same income is taxed in two countries, but credit is not fully available for the tax charged in one country against the tax charged in the other.

Q. In your meetings, did you perceive a consensus by the various countries that double taxation was an impediment to international trade?

A. Yes.

Q. Did you also perceive a consensus among the nations that there was an attempt to discourage overseas investment?

A. Certainly not to discourage overseas investment. I think the important thrust was that tax should not be any obstacle to overseas investment, to the free flow of income between countries. The policies of different countries might differ as to whether overseas investment was to be specifically encouraged through the tax system, but the essential point, I think, in OECD was to insure that it did not act as a discouragement.

Q. Double tax would act as such a discouragement; is that correct?

A. It would.

* * *

[p. 1066] Q. Now, in January of 1984, Mr. Taylor Thompson, you assumed the chair of the OECD Fiscal Affairs Committee.

In the January meeting of the OECD Fiscal Affairs Committee, was the issue of worldwide combined reporting by certain states of the United States discussed?

A. Yes, it was.

Q. And what occurred?

A. As I recall, as members of the Fiscal Affairs Committee, we were concerned about the Working Group which had been set up in the United States, and there was discussion at the Fiscal Affairs Committee of the appropriate way of making views of

member countries and of the OECD itself known to the Working Group.

There was also some general discussion about the implications of the worldwide combined reporting method and the fact that it was, of course, contrary to the provisions of Article 7 and Article 9 of the model treaty.

Q. Was there concern about possible spread of the use of worldwide combined reporting at that meeting?

A. Yes, I think so. It's difficult to remember after so long just what was said at a particular meeting, and of course, perhaps I should stress that the details of what were said at the meetings are confidential, but I can certainly say that there was discussion, if not at that meeting, then at another meeting of the Fiscal Affairs Committee of the possible spread of worldwide combined [p. 1067] reporting to other countries.

Q. Was this perceived as problematic?

A. Yes.

Q. And what was the reason?

A. Well, there was concern that if worldwide combined reporting was spread to other countries, it might have a serious effect on international trade for the same sort of reasons as worldwide combined reporting was seen as having a serious affect on trade with the United States, and in California, in particular.

In the statement that you've already referred to as Exhibit 30-A, there was concern about the compliance costs of the method. There was concern about the possibility of unrelieved double taxation which would result from it, and their general concerns about its effects on international trade and advancement.

Q. Was there also concern that adoption or spread of the worldwide combined reporting methodology would cause a breakdown in the system of international cooperation which had been attempted to be developed by the OECD?

MR. MILAM: Objection, asking for an opinion.

THE COURT: The question is: Was there concern, presumably expressed at the meetings, and that's objective, not opinion. I'll overrule the objection.

THE WITNESS: Yes, as I recall, concern was expressed.

* * *

[p. 1069] Q. In August of 1984, did you participate in a British delegation to the State of California expressing concern about California's use of worldwide combined reporting?

A. Yes.

* * *

[p. 1070] Q. Mr. Taylor Thompson, is this the first time, to your knowledge, that Her Majesty's Government—a representative of Her Majesty's Government has gone directly to the states to discuss international problems which have arisen as a result of the state taxation system?

A. Yes. To the best of my knowledge, it had not happened before.

Q. Mr. Taylor Thompson, did representatives of the United Kingdom visit other states of the United States to discuss problems associated with the states of the United States using worldwide combined reporting?

A. Yes.

Q. To which states were those?

A. I recall Florida in particular. I was not myself involved in any of the visits to the other states, so I can't speak with authority about this, but I recall there were—there was a visit to Florida.

* * *

[p. 1073] Q. How much time did the OECD Fiscal Affairs Committee meeting spend on issues regarding the states' use of worldwide combined reporting?

A. Well, it has been on the agenda of each meeting of the Fiscal Affairs Committees that I have chaired, so going back to

January of 1984, twice a year since then, we have had a discussion of the issue in the light of developments.

The United States' delegate has reported on development, and he's been questioned about them, and there has been general discussion which, as you have already indicated, in some cases led to notes being sent from member countries and from the OECD itself.

So it was on the agenda on each occasion and on some occasions took up quite a bit of time of the committee.

* * *

[p. 1074] Q. And was there a reason that the worldwide combined reporting issue was placed repeatedly on the agenda?

A. Because it was a matter of concern to all member countries and because, as we saw it, it did affect international trade and investment, and it was, therefore, very proper that as an international tax matter it should be discussed by the committee.

* * *

[p. 1077] Q. In July of 1985, the United Kingdom Parliament passed retaliatory legislation.

Was this noted in the OECD Fiscal Affairs Committee meetings?

A. Yes.

Q. Did you learn that any other member countries were considering similar legislation at that time?

A. No.

Q. Were other—did other member countries discuss the possibility of enacting retaliatory legislation?

A. There was certainly some discussions of appropriate reactions, and different countries took different views on what would prove to be most appropriate for them.

But as I'm saying, it was only in the United Kingdom that action was taken to legislate in this way. That was duly noted by

the Fiscal Affairs Committee and accepted as a reasonable response for the United Kingdom.

* * *

[p. 1084] Q. Shifting back to the reservation that the United States has made both to the OECD Model Treaty and the United Nations Model Treaty, what is the effect of such a reservation?

A. The effect of such a reservation is that it's seen as an indication of the line the United States and the other countries mentioned will adopt in negotiating treaties. It doesn't in any sense bind them. It's just an indication that they do have a reservation on this part of the model treaty, and, therefore, it's to be expected when they negotiate bilateral treaties, they will have regard to that reservation in the way they do it.

* * *

EXCERPTS OF DAVID R. TILLINGHAST

* * *

[p. 1111] having been first duly sworn according to law, upon his oath testified as follows:

DIRECT EXAMINATION

BY MR. JORDAN:

[p. 1116] Q. Now, I take it, then, that you are familiar with the standards of the world regarding taxing jurisdiction for foreign multinational corporations?

A. Yes, I am.

Q. And can you briefly just give us what that jurisdiction is based on?

A. Well, in the most generalized way, I think the ideas are three. The first is that countries assert the right to tax the income of persons or legal entities based on the fact that those persons or entities are resident or domiciled in the jurisdiction, and thus, for example, the United States would tax the income of a corporation

incorporated in the United States wherever that income would arise.

And that practice is, with variations, followed through the world.

The second basis of taxation is what we call the source basis of taxation, and that arises because it is customary and accepted throughout the world that nations will tax income that arises from activities carried on or property located within its borders, even if that income is derived by a person who is foreign in the sense that that person or entity is not domiciled or resident of the jurisdiction.

And I think the third general—

[p. 1117] Q. Excuse me. Does this refer to—or this method or this piece of jurisdiction referred to as "permanent establishment"?

A. Well, yes. The basis of assertion of jurisdiction—may I rephrase that?

The assertion of jurisdiction based on source is usually predicated on the taxpayer being engaged in some kind of business activity in the jurisdiction, and that means that there must be some activity or presence in the jurisdiction before the source jurisdiction to tax will be asserted.

As a general rule, although there are exceptions clustering around the general rule, this level of—I'm sorry, the level of activity which is required to be carried on in a country before that country will tax has to be a fairly consistent and ongoing conduct of business, and there is a concept which has been built up through the treaty system which says that a source tax will be imposed on this basis only if the activity is carried on in the jurisdiction through something called a permanent establishment, which a laymen would refer to, I think, as a branch.

Now, as a footnote, there are some types of income that are customarily taxed at source without regard to a permanent establishment, and that would be represented by the practice of nations

following of imposing withholding tax on interest dividends or royalties that are sourced in the jurisdiction.

* * *

[p. 1124] Q. Now, as far as the standard of the world concerning taxing jurisdiction, we have discussed, first of all, the nationality or residence of the taxpayer.

A. Yes.

Q. The source of income, and what is the third basis for jurisdiction?

A. Well, I think that those are the two primary bases for jurisdiction. I think that the third principle which applies is that in the exercise of jurisdiction based on source or jurisdiction based on domicile, each legal entity is considered a separate taxpayer to whom jurisdiction is separately applied.

There is—the result of that would be, for example, that if a corporation which is resident in country "A" operates in country "B" through a subsidiary, but not otherwise, the subsidiary would be considered subject to [p. 1125] jurisdiction to tax in country "B" on the basis of its residence or domicile, but corporation "A", its parent, would not be subject to jurisdiction to tax in country "B".

* * *

Q. Okay, let me just interrupt you there.

Can we start with the approach or the concept of separate entity?

A. Um-hum

Q. Could you specifically describe that for the Court as to how that works in international taxation—

A. Well —

Q. — as a standard of international taxation?

A. I think it works at two levels. The first level involves related legal entities to which I referred to the example I gave before.

And it proceeds on the basis that if a legal entity is subject to the jurisdiction of a country to tax, that does not imply that a related entity is subject to that jurisdiction.

The second application relates to the taxation of a permanent establishment or branch that is located in a country. And the general standard of taxation is that in the [p. 1126] case in which a company which is a resident or domiciled in one country has a permanent establishment or branch in the other country, the amount of income of that branch which is subject to tax in that other country is determined as nearly as possible on the basis that that branch is—it is a separate entity and its income subject to tax is determined as nearly as possible as if it were in fact a separate entity.

* * *

[p. 1128] Q. Now, is there any country in the world that is [p. 1129] not in accord—or does not operate its taxing power on multinational corporations that is not in accord with the separate entity method?

A. There is not.

Q. And I may have asked—I—or I do ask you: Is this the custom of nations in regard to international taxation?

A. Yes.

* * *

[p. 1131] Q. Now, just to go back to how this standard came to be, can you testify of your own knowledge where this concept evolved or how it evolved? How long has it been in existence?

A. Well, I ought to divide that into two parts because from personal experience, I can only testify to events that have occurred since 1957. I regret it's been that long, but not longer—but I do think —

Q. Well, you can rely on your studies and—

A. Yes, I can. I think I can comment on what had preceded that since I have spent a considerable amount of time studying that, and I think the answer to that is that [p. 1132] efforts began

to be made as early as 1922 in the League of Nations to see if a basis could be derived for harmonizing those aspects of international tax rules which were not already harmonized.

And the League of Nations appointed a committee of experts in that year which eventually delivered a report and deliberations went on, and then there was a further round—if that's the correct word to use—in 1932 and 1933 is my recollection, in which there was a convening of a committee of experts by the League of Nations and the committee deliberated and presented a report in which it recommended that the nations of the world proceed to deal with international tax jurisdictional matters on the basis of the separate accounting standard. And to a certain extent, to a large extent, that reflected the domestic law of the nations of the world at that time. Certainly, major nations of the world already embodied that in their law, and commencing really from the early '30s, there was a building of consensus, if you will, on that basis through the expanding conclusion of bilateral tax conventions or treaties among the major trading nations of the world.

Q. Is there any distinction between developed and developing countries, to your knowledge, as far as the acceptance of this standard?

A. No, to my knowledge, there is not.

* * *

[p. 1140] Q. Now, what is the expression in international commerce of "harmonization of tax treaties" or tax—

A. Well, the concept of harmonization of tax rules is a concept that trade and investment and flow of services will be freer and more rationally allocated to the extent that the tax rules of the various nations among which these flows occur are the same or at least very closely similar.

Harmonization refers to an effort to try to take disparate tax rules and make them as much as possible the same to avoid double taxation or arbitrary taxation or the kinds of things we talked about before.

Q. And would that goal be including avoidance of whipsawing between various nations as to tax dollars?

A. Yes, it is, certainly. I think there are sort of two sides to the coin, and that is, if there is lack of harmonization, one possibility is that the taxpayer or the enterprise bears the burden of that by being taxed more than once or at excessive rates.

Obviously, there is another side of the coin: If the rules are not harmonious, it is possible that gaps can occur into which income may fall and taxpayers use that kind of disharmony to—we call it whipsawing because you play off one rule against the others, which are not symmetrical, [p. 1141] and there was—there is an excluded middle.

* * *

Q. Now, I take it that in addition to the United States trying to harmonize tax arrangements, this has been the goal of all governments in the world to avoid double tax and standardize their taxation?

A. I think it is a goal which is shared by all the major Free World nations—

The only reason I'm carping is I'm not sure that the Socialist nations have always had exactly the same goals.

Q. Could you characterize this effort as—

A. It's been an ongoing—I would say that it's an ongoing, continuous and—effort which is given prime importance by the people and the nations who are participating in it.

* * *

[p. 1172] Q. Now, you also testified that the custom of nations asserts these two kinds of jurisdiction by regarding each legal entity as a separate taxpayer. Does this mean that the host country would ordinarily have no right to tax another corporation unless the income of that corporation arose in the host country or that corporation was a domiciliary of the host country?

A. Yes, that is correct.

Q. What is the custom with regard to branch income?

A. The, I think, generally accepted rules are that if a company located in another country establishes a branch in the host country, the host country may tax the income which arises from the activities of the branch and that income is generally determined as nearly as possible on the basis that it would be determined if that branch were a separate legal entity.

Q. Do you know of any nation in the world that asserts jurisdiction to tax a branch on a different basis?

A. No, I do not.

* * *

[p. 1176] Q. But in no case, however, will that country take into account income of a related corporation that is neither a domiciliary, nor has its source in that country?

A. That's correct.

* * *

[p. 1214] Q. Now, is there any international tribunal or forum to resolve international disputes over the apportioned formula—the worldwide apportionment formula or tax issue?

A. Not to my knowledge, no.

Q. Does this create problems?

A. Well, it creates problems in the sense that someone who has suffered double taxation as a result of the application of the worldwide combined reporting method has no [p. 1215] recourse.

Q. Now, you testified earlier that administrative double tax can arise under separate entity arm's-length method.

Can this administrative double tax arise under worldwide combined reporting?

A. Well, certainly, not at the moment because there is no one else who employs the method, so there would be no administrative double taxation.

If there were two systems in the world that employ the same method, then the same problems would arise only in a different name. We would be having administrative double taxation be-

cause of inconsistent application of the apportionment formulas, or something like that.

Q. Is there a difference in degree or implication from the type of double tax which arises because of the clash of systems such as worldwide combined reporting and separate and arm's-length imposed—let me start all over.

Is there a difference in degree or implication from the type of double tax which arises because of the clash of systems such as worldwide combined reporting and separate entity accounting as opposed to that arising because of administrative decision?

A. The answer is yes. I mean, if everybody who is concerned with the problem is attempting to apply a separate accounting standard, there may be differences in rules which may create a double tax problem. There may be differences in [p. 1216] administrative determinations that will create a problem.

But everyone, after all, is trying to do the same thing. And therefore, while there were problems, they are fairly—they are not minor problems, but they are limited in scope.

With a comparison between a separate accounting method and a worldwide combined reporting method, the problem is that no one is doing the same thing. They are doing something entirely different, and therefore, it's—you know, it's just not—it's not even trying to do the same thing.

* * *

Q. Well, does the double taxation have any implication for government in addition to the ones you've cited as well as for the taxpayer?

A. Oh, it certainly does. I want to make that clear. If I didn't, I apologize.

If a country has a company that derives income sourced in another country and that other country imposes a tax on a base which is duplicative of the base that the—that the residence country maintains, either the taxpayer is [p. 1217] going to suffer or that government is, and I don't know which one until I know the amounts of the tax, because it is possible for a source country

to impose a tax at a low rate but at a—on a high base of income and come to a tax that may, through accident, be actually fully creditable.

In that case, the taxpayer has not suffered an increase in its tax level, although there has been a duplication of tax. The sufferer of the onus of that is the Treasury of the residence country, which has given a credit for a tax imposed at a low rate on a segment of income that it treats as being rightfully its own, and therefore, it has the right to the tax.

So, the impact doesn't always fall on the taxpayer. It falls on the revenues of the residence country as well in some cases.

* * *

[p. 1222] Q. What establishes the international standard from your point of view?

A. The fact that the same general rules are applied throughout the world by all the nations in their domestic legislation, in the income tax treaties to which they have become parties, and in the model conventions which have been prepared by the organizations of which they are members.

* * *

CROSS EXAMINATION

BY MR. MILAM:

[p. 1249] Mr. Milam: Yes. A paper entitled "Thirty-first Annual Conference, Canadian Tax Foundation, An American View of International Intercompany Pricing Problems" by David R. Tillinghast.

(Whereupon Defendant's Exhibit D was marked for identification.)

Q. (By Mr. Milam): Did you make that presentation?

A. I did make such a presentation. I'd have to read it to be sure, but this looks like the piece.

[p. 1250] Q. Would you turn to page 15?

A. Yes.

Q. And would you read the second full paragraph?

A. You want me to read the part that says "In such a case, the plain fact, which of course must never be mentioned, is that there is no such thing as an arm's-length price. There is no comparable uncontrolled price, and often, there is no very reasonable way to apply the resale price method or the cost plus method."

Q. Yes. And would you continue with the rest of that?

A. Oh, continue. "Thus, under the rubric of 'other,' it is necessary for the Internal Revenue Service and the affected companies to work out ad hoc solutions.

"Sometimes this works well, but sometimes it leads to disputes of particular bitterness engendered largely by the lack of clear principle."

Q. Now, this fourth method that you have said was in the regulations and you have described in your talk to the Canadian Tax Foundation, by its very nature, you cannot establish international standard, can you?

A. I don't understand that question. If I understand, what is going on here —

MR. JORDAN: Let him rephrase it, Mr. Tillinghast.

THE WITNESS: All right.

Q. (By Mr. Milam): The fourth method that you have described as in the regulation and in your speech to the—or talk to the Canadian Tax Foundation, by its very [p. 1251] nature is not precisely used by other countries, is it?

A. Well, the problem—I now see the problem I have with the question. Let me back up.

What we are talking about here is determining the separate income of two legal entities or the branch and the home office which are related, and the objective of the exercise in the United States, as elsewhere, is to determine that income as nearly as may be as if each of those entities had operated separately and dealt in

the same manner that it would have dealt with—had dealt with unrelated parties.

That's the object of the exercise. Now, what the comment that you quoted related to and what the question relating to "other" methods relates to is the fact that, particularly in vertically integrated enterprises, there are transactions which involve transfer prices for the passage of goods or services between related parties for which there is no comparable transaction between unrelated parties, and therefore, in that sense, there is no arm's-length price.

Now, under those circumstances, the tax authority has to make a determination of what is the most reasonable way which will conform as closely as may be, anyhow, to a separate accounting standard to determine what would be a correct price.

And there are various ways in which this can be done under the rubric of "other" an what is done under "other" depends upon a judgement of the tax administrator at the time as to what is the most reasonable way to come to the closest possible approximation of separate accounting income.

[p. 1252] Now, "other" is, therefore, not a method. It is a way of trying to cope with adjusting prices in cases where there is no specific method that is applicable, and therefore, some method must be used.

Now, I am sure—although I can't swear to it—that there are many cases in which the way in which an Internal Revenue Service agent responds to that situation is very much the same in which an agent in another country responds to it, and there may be cases in which it is different. I just can't tell you.

Q. Where—there is no exact symmetrical application from country to country of transfer pricing method, is there?

A. Not necessarily, that's right.

* * *

[p. 1259] Q. (By Mr. Milam): Doesn't Article 7 of the OECD convention authorize formula apportionment?

A. In the case of determining the income of the permanent establishment located in one country of a legal entity which is resident in another, under limited circumstances, it does contemplate a form of formula apportionment, yes.

Q. Does the worldwide combined reporting that California uses also utilize a form of formula apportionment?

A. What the California method does—you may characterize it, if you wish, as formula apportionment, but what it does is something entirely different. It takes income of multiple legal entities and it then apportions it to the state according to a percentage derived by formula factors. As you know, that's an entirely different process [p. 1260] from what is done in the case of determining the income of a branch under the OECD treaty—your Honor, I'm sorry, it's under the convention.

* * *

[p. 1269] Q. Isn't it correct that under what you refer to in your Canadian talk as a rubric of "other" in the regulations, isn't it true that many times formula apportionment is used to determine the approximate separate accounting income?

A. Well, we are back to the old shibboleth of what's formula apportionment.

In my experience, I can only tell you that in cases in which a price is being determined under "other," the most usual way or kinds of way in which the IRS seeks to do that is by examining transactions that have passed from—between [p. 1270] related parties, and attempting to divide, if that is the correct term, the profit which was derived by the sale of the ultimate goods to an unrelated person between the two entities, or if there are more than two entities, the entities that participated in that sale.

Now, the basis on which that division of profit is made varies according to the judgement of the auditing agent and the IRS as to what would produce a reasonable approximation of what an arm's-length price would be.

For example, it's not unusual for Internal Revenue Service agents to take the view that a profit on an ultimate sale ought to be divided between a sales subsidiary and a manufacturing parent

in accordance with the relationship of the costs of each of those parties that were incurred in the course of manufacturing and selling the goods involved.

Now, if that is a version of formulary apportionment, then that is formulary apportionment. But I emphasize, in that process, nothing is done to take account of the profits of any entities that may be related to those entities or of any revenue or costs that either of the participating entities may have had which are unrelated to the transactions as to which the price is being established.

* * *

[p. 1277] Q. If Barclays Bank International Limited, which is a United Kingdom corporation which does business in California, received a full tax credit in the United Kingdom for taxes paid to California, there would be no actual double taxation, would there?

A. In that case, the complainant is the government of the United Kingdom and not the taxpayer.

Obviously, if the taxpayer receives a full credit in the United Kingdom for the amount of tax that has been imposed here, its tax bill has not overall been increased, that's true. The complainant in that case is the United Kingdom who will have—who will consider that it has been deprived of revenue that it should rightfully be entitled to because the California tax may have been imposed on a base that's too large.

* * *

[p. 1308] Q. Disregarding what other nations do, in your opinion, is the unitary business formula apportionment method employed by California a proper and fair method of taxation?

A. I don't know how to answer that question. The only thing that springs to my mind, Mr. Milam, is something that I understand has been used by a prior witness, so I embark on the statement with trepidation, but it's the only one that springs to mind. I don't have any inherent reason to believe that it's better to drive on the left-hand side or the right-hand side of the road, but I think everyone ought to drive on the same side.

EXCERPTS OF STEPHEN WETZEL

* * *

[p. 1421] having been duly sworn according to law, upon his oath testified as follows:

DIRECT EXAMINATION

BY MR. NIELSEN:

[p. 1543] THE COURT: I'm going to handle it this way: I'm going to ask the witness a question too.

Is it customary, Mr. Wetzel, when the Franchise Tax Board is confronted with a protest to negotiate and, if [p. 1544] deemed appropriate by the Board as a result of those negotiations, adjust the amount of the assessment?

THE WITNESS: Yes.

THE COURT: And does the Board have a custom and practice of using and taking into account certain factors and certain circumstances in making those adjustments where they are made in such a way as to be favorable to the taxpayer?

THE WITNESS: Yes.

THE COURT: And were those type—were those factors, those same factors that are customarily used with all taxpayers, not just banks, but with all taxpayer entities, were those same factors the ones used here or was there any different—was this taxpayer treated any differently.

THE WITNESS: No. No, it was not treated differently. Of course, each taxpayer—

THE COURT: I understand.

THE WITNESS: —is different to some degree or another in the context of that differness (phonetic). The treatment is the same, yes.

THE COURT: It is more of a uniform practice of the Board to negotiate and to adjust where it deems appropriate; is that not so?

THE WITNESS: Yes. Certainly.

* * *

[p. 1545] Q. (By Mr. Nielsen): Mr. Wetzel, what were the basic sources of information relied upon by the Franchise Tax Board in this audit?

A. The annual reports for BBI, BARCAL, the prospectus and additional information submitted at the protest proceedings through Joanne Garvey.

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EXCERPTS OF COURT & COUNSEL

* * *

[p. 1548] MS. IRION: Your Honor, that's not relevant. We are not here talking about whether the unitary is good or unitary is bad. We are talking about the issue in the case and whether or not there is an international standard. I fail to see the relevance of how we go into whether or not unitary is a good method or economically-fair method.

THE COURT: No, as I remember from reading the [p. 1549] several Supreme Court cases that ultimately this will be the crux of my decision here, one of the basic requirements for a unitary tax to be—to be constitutional is we have to start with the tax being a fair—a fairly-assessed and a fairly—fairly-allocated tax.

MS. IRION: Your Honor, we are not claiming distortion in this litigation.

THE COURT: And that is not an issue?

MS. IRION: No.

* * *

[p. 1551] THE COURT: No, the point, as I see, is to show that—that—for whatever it is worth to demonstrate that the formula the way the State of California has it created and applies it is not—is not an unfair formula, and to that extent, I guess I've gotten myself tongue-tied here because I think I already said that.

If that is not an issue so far as the Plaintiff is concerned, then there is a lack of relevance.

MS. IRION: It's not, your Honor. We are not arguing that the three-factor formula is an unfair apportionment factor formula, and we are not arguing distortion. They are not issues in this case. And the exhibit and the testimony is absolutely irrelevant and immaterial.

* * *

[p. 1552] MS. IRION: Well, generally, adjustments are proposed by the taxing agency to begin with.

Second of all, if you are talking about the regulations, the regulations talk about adjustments which are material, not a $10 million material difference between the worldwide income. So that is a completely irrelevant inquiry.

If you are talking about reasonable approximations, the regulations themselves say that no reasonable approximations shall be used unless the information is [p. 1553] unavailable, and the fact that you are asking this witness—you are asking him to opine with insufficient foundation without a purpose to state. There is nothing in the record that says we are arguing distortion. There is nothing in the record. And there is no allegation of—the three-factor formula is not even in issue.

* * *

EXCERPTS OF JOHN ERIC BISCHEL

* * *

[p. 1645] having been duly sworn according to law, upon his oath testified as follows:

DIRECT EXAMINATION

BY MR. MILAM:

[p. 1679] Q. Are there differences between nations on what constitutes sources of income?

A. There are probably as many differences between nations on what constitutes sources of income as there are nations in the world, which I think are about a hundred and thirty.

Some of the significant differences—an example might be, for instance, the fact that the United States taxes under certain circumstances imputed interest, whereas Canada won't allow a deduction for it, views it as being a Canadian source income.

So there is substantial differences as between countries of over what is—what ought to be sourced in the country.

[p. 1680] For instance, Latin American countries, their impression of what ought to be taxed is everything that they can get their hands on is domestic sourced.

We look at Argentina, Brazil, Venezuela, those countries in particular have a very broad definition of source taxation, and in any international meeting that I've been at, it's been brought home when the Latin Americans are present. They have a very good concept of—

Q. You mentioned imputed interest. I want to clarify the record what you mean by imputed interest and the the—why that's an example of different sources. It's not clear on the record. I don't think I really understand why there is a difference.

A. Well, that would simply be, really a situation in which the United States has—we have—because of imputed interest rules, certain income has arisen within the United States, and Canada would say, "Well, that may be, but we are not going to allow a deduction for it because as far as we are concerned that wasn't income in the first place."

That would be really a situation of what is and what isn't income, and different souring rules as to even what constitutes income as well as whose income is it.

Q. Is the allocation of income for tax purposes a common problem in international taxation?

A. How much time do we have this afternoon? Do I have enough time to answer that question?

It is a—it's a very serious problem under the separate accounting method, and there are a number of [p. 1681] important reasons. The—probably some of the more basic or principal reasons are the fact that different jurisdictions simply take different positions on what ought to be sourced in those particular jurisdictions.

If nothing else, the very existence of the competent authority procedure in the treaties obviously indicates that there are huge differences in terms of how and what ought to be allocated under the separate accounting methodology between jurisdictions.

And large taxpayers sometimes take a divide-and-conquer approach to that particular problem just between jurisdictions.

So there are significant problems, both from the administrator's point of view—there is—there is an article which is quite a good one entitled—

* * *

[p. 1770] Q. (By Mr. Milam): In your opinion, is the separate accounting method of allocating income the international standard for income allocation?

* * *

[p. 1771] THE WITNESS: Well, when I think of a—of a standard, I think there is something in terms of perhaps weights and measures. Everyone decides that this much is an inch (indicating) or that much is a gallon (indicating), and everyone agrees that that's exactly what it is.

Even—and I suppose in the weights and measures, we've—we certainly have differences. The English have what we call long ton on a metric basis. They call our ton a short ton.

We have a U.S. gallon, and they have imperial [p. 1772] gallon. And certainly there are—

MR. JORDAN: I'll—

THE WITNESS: There are different systems both—

MR. JORDAN: Can we have an answer to the question, your Honor?

THE COURT: He is answering it. He is answering it in the way many experts answer questions. Overruled.

THE WITNESS: To continue, certainly there are—even with regard to weights and measures, there are metric systems versus the English system.

There is a worldwide standard, if you want to denominate it as such—it's not my understanding that it really is a standard in the sense that I just described—called the arm's-length separate accounting standard. But that doesn't mean that all the tax administrators in the world are arm in arm marching in a lockstep singing arm's-length to the hallelujah chorus choir. It just doesn't happen that way.

There are many, many differences in terms of the application of that particular standard. Maybe it is what Professor Surrey said many years ago, and he was one of the greatest proponents of the arm's-length standard—in his terms from Harvard—that he indicated that indeed it was a goal.

In other words, it's something that the people strive for, but there's a great divergence in terms of the application of it.

Q. (By Mr. Milam): Is it your opinion that the [p. 1773] separate accounting arm's-length method does not set a standard for the procedures used in allocating income to jurisdictions?

A. No, it does not. The reason being that as a practical matter, there are relatively few jurisdictions that have any substantive description of what they mean by the arm's-length standard, outside of the United States, Canada, Germany, perhaps a bit in France. So really, it's—as Marshall Langer described it, it's really whatever the tax collector says it is going to be.

Q. Who is Marshall Langer?

A. Marshall Langer is a good friend of mine. He's an international tax expert who has done a lot of writing on—particularly on tax treaties. He is probably the most renowned expert in the country in that particular area. He now resides in Neuchatel, Switzerland.

Q. Is it your opinion that the separate accounting arm's-length method is a standard in name only?

A. Yes. Yes. I might add that that's on the basis of—of 20 years experience in the practice in this area as well as being a part of the United Nations Secretariat and sitting through what may seem at the time to be interminable hours of the discussion between tax administrators from developed and developing countries of what—how they ought to really allocate income.

And there are volumes and volumes of pages that I have that I supplied in my deposition. I think I probably put in about ten times as much as any other expert witnesses, [p. 1774] probably about 3,000 pages, which described the proceedings in the United Nations and a number of other articles as well, which simply indicate that there has been a lot of difference and remains a lot of difference over ways—and what is the arm's-length standard, if anything, and how it is to be applied.

It's kind of a joke to be very honest. When we go to international meetings, we stand outside the meeting room and we listen to what's going on inside at the International Fiscal Association congresses, and the vital issues we're talking about, we always look at one another and say, "They are not talking about international income allocation."

And we find that that subject, as a practical matter, is never dealt with on a—really on an adequate basis, and it's not dealt with, for instance, in the treaties. The treaties say nothing about standards for international income allocation. No substantive standards for 50 years.

* * *

EXCERPTS OF COURT AND COUNSEL

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[p. 1815] MR. MILAM: Your Honor, Professor Bischel will testify that worldwide combined reporting method, as applied to foreign parents, does not violate the nondiscrimination clause of U.S. income tax treaties.

* * *

[p. 1821] MR. JORDAN: Well, I also object on the ground of irrelevance as well, which is the Court's suggestion at this point.

THE COURT: Well, if you do that, I'll sustain it. I have not perceived an issue, and your case is closed. You presented your case, and I have not heard any claim asserted, nor have I picked it up in the pleadings, that the nondiscrimination clause plays any role in the claim for the refund here or the claim of constitutionality of the tax as levied.

MR. MILAM: Well, if they'd stipulate, I will withdraw my question.

THE COURT: Well, they really don't have to stipulate. They put on their case. I'm making my ruling that I haven't heard it and it's not an issue.

And they don't say that there is an issue, which is [p. 1822] the equivalent of a stipulation, and that being so, there is no relevancy to this inquiry.

I have, all along, been curious to know and I've been educated and I do know and I'm satisfied to know what the nondiscrimination clause is, but it really doesn't apply in this case.

MR. MILAM: Well, if it does not, then I will move on, your Honor.

THE COURT: I assure you that I'm going to treat it as inapplicable, and unless somebody moves to file an amendment to the complaint and I'm inclined to grant it, which I'm not, or I wouldn't know—

MR. JORDAN: I think it's in the complaint somewhere, but we haven't addressed it.

MR. MILAM: I believe it's in the complaint.

THE COURT: Oh, that's why you pursued it. I see.

MR. JORDAN: There's no evidence

MS. IRION: It's just a matter of law.

THE COURT: I'm sorry?

MS. IRION: Your Honor, we did plead in the complaint a violation of that particular section, except as a matter of law, the argument, we have done nothing except in terms of what the burden in—it's just a question of a matter of law than anything else as far as we are concerned.

THE COURT: I can see now. I read the complaint certainly, but I've forgotten that it was there because ever since I read it, we have been through the Plaintiffs case and there has been no—no pursuit of that inquiry or that [p. 1823] subject, so therefore, I now, with the comments I have from Plaintiffs' counsel, it certainly is a relevant matter.

MR. MILAM: I withdraw my withdrawal of my question. It's—the issue is still in the complaint. I withdraw my question—the question on the record earlier because I thought that they had agreed it wasn't an issue.

Now that it is an issue, I would like to reinstate the question that I had.

THE COURT: Did they state it as an issue?

MR. MILAM: That's what I heard.

THE COURT: I didn't understand them to state that. All they said is that they had pleaded it in the complaint.

MR. MILAM: Yeah.

THE COURT: But they presented no evidence.

MR. MILAM: And they are going to argue in their brief that worldwide combined reporting violates the nondiscrimination clause. That's what I heard. She didn't say it that way.

MR. JORDAN: As a matter of law.

MR. MILAM: Yeah.

MR. JORDAN: But that's a matter of law. It's not a question of evidence.

THE COURT: Well, now can it be divorced from the question of evidence? No. If you are going to argue it as a legal issue in the

case, then I cannot sustain the objection on the ground of relevancy.

MR. JORDAN: At this time, your Honor, it is perfectly clear, the Plaintiffs will withdraw that issue from [p. 1824] this case.

* * *

EXCERPTS OF JOHN K. SHANK

* * *

DIRECT EXAMINATION

BY MR. MILAM:

[p. 1985] having been first duly sworn according to law, upon his oath testified as follows:

[p. 2014] Q. What would it mean to you to be in full technical compliance with these rules? What does the term "full technical compliance" mean to you?

A. I guess what's in my mind is I'm trying to separate out discussions had in deposition and what's already in trial and what I should say now.

When you say the word "full technical compliance," that has sort of two meanings to me. One is if you say full technical compliance, taking the full extent of the regulations which includes what I will call the relief clauses at the end, then that's one definition of full technical compliance.

Now, back it up, another definition that I think could be used called full technical compliance would be to try to be in compliance with that law, if it were not with those regulations—if it were not for the relief clauses, quote-unquote, at the end.

In that sense, I know there is already some of—some of my deposition's entered in as evidence here.

In that second sense, full technical compliance meaning without benefit of the relief clauses, then my opinion is I don't believe

any business could be in full technical compliance with those regs, foreign, domestic or otherwise.

Q. You're a step ahead of me.

A. I wasn't sure what you exactly asked me, I'm sorry.

Q. In your deposition, you define full technical [p. 2015] compliance as your second —

A. Yes, stopping short of that section (e).

Q. Okay. Now, when you say the relief clauses, would you indicate to the Court what you mean?

A. Yeah. The place where I can most readily find them is in this version, which is called "M" and it's section 5(a). I don't know whether—here —

Q. It's Subdivision (e)(1).

A. Under 6, (e)—6, (e).

Q. It's subdivision (e), I believe.

A. Yeah. I'm sorry, I can't find it in that version. If you can—

MR. MILAM: May I approach the witness, your Honor?

THE COURT: Yes.

THE WITNESS: I have it in front of me.

MR. JORDAN: You can even lead him on this part as far as I'm concerned just so the record is clear.

MR. MILAM: Pardon?

MR. JORDAN: You can even lead him.

THE WITNESS: Okay, I now find it. Yes, it's section (e), "Application of regulation," there are, then, two sections of that.

That's the part which I'm calling the relief clauses.

Q. (By Mr. Milam): Okay.

A. Reasonable approximations will suffice.

And my opinion is were it not for the existence of that section, it would not really be possible for a [p. 2016] corporation to be in technical compliance with these regulations because they are very onerous.

Q. Now, (e)(1) deals with the use of reasonable approximations?

A. That's correct.

Q. And (e)(2) deals with advanced determinations from the Franchise Tax Board; is that correct?

A. That's my understanding, yes, sir.

Q. You stated that a corporation could not be in full technical compliance with the regulations as you have defined it in your deposition and without the relief clauses; is that correct?

A. That's correct.

Q. Is that true for a domestic U.S. parent and multinational?

A. I believe it—put it this way: There are additional calculations for the foreign-based multinational, but there is sufficient calculations in here even for the domestic-based multinational, but I still believe technical compliance would be very difficult.

Q. And then would it be difficult for a foreign parent multinational then even to comply with—to be in full technical compliance as you have defined it?

A. I believe it would, sir, yes,

MR. MILAM: Would you read that question and answer back again?

(Record read as requested.)

Q. (By Mr. Milam): Would it be possible for a [p. 2017] foreign parent multinational to be in full technical compliance without the relief provisions, in your opinion?

MR. JORDAN: I'll object to that. All things are possible, your Honor.

THE COURT: I'm sorry. Would it be possible; is that the form of the question?

MR. MILAM: Yes, your Honor.

THE COURT: The objection is overruled.

THE WITNESS: I'll answer in sort of—sort of the spirit of the objection. All things are possible.

Would it be possible? I believe in a cost effective way in my opinion, no, it would not.

Q. (By Mr. Milam): It would not be possible in a cost effective way?

A. Were it not for those relief clauses; that's correct.

Q. Would it be possible in a cost effective way for a U.S. domestic multinational to be in full technical compliance with these regulations, again, without the relief provisions as you have described it?

A. Possible, yes. Possible. In a cost effective sense, probably not.

* * *

[p. 2019] A. On a cost effective basis, in my opinion, no.

Q. And why not?

A. Again, because those provisions require essentially a parallel accounting system. That would not be cost effective just for purposes of compliance with California tax if it were not for the possibility of the relief clauses.

* * *

[p. 2022] Q. (By Mr. Milam): In your work for the World Bank, you've been in, I think, three different countries?

A. That's correct.

Q. In your experience in those three countries, did those corporations maintain records which would set forth their gross receipts?

A. Yes, they did.

Q. How about their historical cost of property?

A. Records that could be used to produce historical cost of properties, yes.

Q. Did that include both tangible and intangible property?

A. Yes, it would.

Q. Would the companies which you dealt with also maintain records which would set forth total rent that it pays?

A. Total rent?

[p. 2023] Q. Rent.

A. That typically would be an item of information available, yes.

Q. And would those—the records that you looked at also include total salaries that those corporations pay?

A. If wages and salaries is total payroll cost, yes, it would typically be available.

MR. MILAM: May I take a short break, your Honor?

THE COURT: All right. We'll take a break.

(Whereupon a brief recess was taken.)

THE COURT: All right. Back on the record.

Q. (By Mr. Milam): I think we finished up before we took a break, Mr. Shank, with your experience in looking at records in other countries.

And I believe you testified that those companies in the other countries set forth their, for example, gross receipts and their accounting methods; is that correct?

A. That would be typically true, yes, in their accounting records.

Q. Those are under the accounting conventions of that particular country?

A. That's correct.

Q. And those accounting conventions may, in fact, differ from U.S. accounting standards; is that correct?

A. They may differ, that's correct.

Q. In the area of gross receipts, for example, what kinds of differences may there be in just your experience in some of these countries between the gross [p. 2024] receipts as indicated on the accounting records in those countries and what it would be under U.S. GAAP?

A. The basic idea is when do you count something as revenue? And there is a range of possibilities as to when you can count something as revenue.

U.S. accounting for manufacturing companies tends to focus on the point of sale.

U.S. accounting for a bank tends to focus on the earning process of the revenue, the passage of time.

In other places in the world, revenue might be recognized closer to the time when the cash is received, for example, rather than when it's earned.

So those are some differences that could lead to a different number for gross receipts depending on the accounting standards being used.

Q. As far as the gross receipts are concerned, from your experience, would the gross receipts under the foreign accounting conventions be reconcilable with that under the U.S. accounting conventions?

A. It's my opinion that they are almost always reconcilable. They maybe different, but they are reconcilable.

Q. And reconciliation means what?

A. Being able to convert from one to the other.

Q. Is that also true for the historical cost of property in your experience?

A. Again, it almost always can be converted from one basis to another.

[p. 2025] Q. And is that the same with the total rents that you mentioned?

A. Yes.

Q. And total salaries also?

A. Yes.

Q. And would it be reconcilable between the two conventions using the information that you had available to you in those countries?

A. That would be true. Yes.

Q. You have testified that the fully—that full technical compliance with the Franchise Tax Board regulations would be very difficult without the relief provisions — difficult, if not impossible, for foreign-based multinationals; is that correct?

A. I believe I said anything is possible if you are willing to pay the cost, but possible in the cost effective sense, without the relief provision, it is my opinion it would not be.

Q. And would your opinion very whether there was a parent corporation with several subsidiaries of whether there was one single corporation that did business worldwide?

* * *

[p. 2026] THE WITNESS: Yeah, in my opinion, the legal form is not a binding constraint.

In other words, this single corporation doing business in multiple locations around the world, of those locations around the world, whether they are branches or divisions or subsidiaries, what the legal form is, they still have the assets in those locations around the world. They still have the revenues in those locations around the world. They still have the payroll in those locations around the world. The problems are exactly the same in terms of compiling aggregate accounting information by one set of standards or another set of standards independent of the legal form.

So whether it's multiple subsidiaries around the world and a foreign corporation or whether it's multiple branches around the world and one corporation has nothing to do with the complexity of the accounting problems. All that affects is equity accounting, if you will. It has nothing to do with asset accounting, revenue accounting, payroll accounting.

* * *

[p. 2029] Q. In your opinion, would it be reasonable for a foreign-based multinational like Barclays to set up a separate accounting system to comply with California tax requirements?

A. Would it be reasonable? Would that involve—would that expenditure be a reasonable expense for them? In my opinion, it would not be a reasonable expenditure for them.

* * *

[p. 2043] Q. And what is your definition of materiality from an accountant's standpoint?

A. I am sorry if this will sound whimsical, but I don't think I can give you a concise, crisp definition of—or any other accountant in the world ever could.

I would come back and simply say: Can you, as an attorney, give me a definition of due process?

You know it when you see it, and you know it when you don't see it.

Materiality to accountants is one of those things like due process to a lawyer. Essentially you know it when it's material and you sort of know it when it's not material, but at the margin, there could be differences of opinion about what is and is not material. And it's extremely difficult to try to write it down or to give it in crisp words, but it certainly does exist.

Q. What function does it play in accounting work?

A. Similar to the function of de minimus non curat lex in the law, I think, so it's—so if it's immaterial, [p. 2044] you don't worry about it.

In other words, you only deal with things that are of sufficiently large magnitude to make a difference in terms of the use to which—to which the information is to be put.

So that's the basic idea. So you don't worry about items that are sufficiently small that they will not change the essential message or the essential uses of the information present.

Q. In your experience—excuse me, strike that.

In your experience in working with tax reporting in your accounting jobs, was there a concept of materiality for tax purposes?

A. In my opinion, there most certainly is.

Q. And how does the concept of materiality for accounting purposes differ, if it does, than the concept for tax purposes?

A. My broad sense of that is tax materiality is a little smaller than financial reporting materiality.

In other words, that in most taxing jurisdictions, the concept of what's immaterial is smaller than the concept of what's immaterial for financial reporting purposes, but there still is certainly a material concept in the tax laws.

* * *

[p. 2045] Q. (By Mr. Milam): In your experience, are determinations of materiality made by accountants without having reference to the precise numbers upon which a comparison can be made?

A. It is my opinion that—that, yes, you very often make materiality judgments without specific reference to the two numbers which are being compared to decide whether the differences of this is material.

* * *

[p. 2058] A. My opinion is that what Mr. Caldwell did for his client in that context is use reasonable approximations. That's the same use of the word approximations that I'm talking about in the context of this litigation.

In my opinion, that's reasonable approximations. Every item—you don't pull them out of the air or make them up.

Every item comes out of the financial records of the company. You're using particular items from the company's books and records just as Mr. Caldwell used specific items. If it turns out that those specific items that the return calls for, you don't have, you use the closest you can—you use what you have that comes the closest that's a reasonable approximation.

So the items that he used when he says there "actual items of income and expense," that's—as far as I'm concerned, that's still using approximations. That's what I mean by reasonable approximations.

So in other words, I believe he did use reasonable approximations even though he chooses not to admit that use of the term.

* * *

[p. 2111] Q. (By Mr. Milam): Professor Shank, in forming the calculation—in determining the figures for the calculation that we went through this morning, how many hours [p. 2112] did you spend in that calculation?

A. I spent approximately ten hours.

Q. And how was that ten hours spent?

A. I spent about one hour making a very rough first-cut calculation, which then I discovered had some serious flaws in it.

I then went back and spent roughly three hours or so with the regs on the key elements, having read the regs before, and having heard reference to them in depositions.

I then spent about three to four hours refining the calculation using the schedules, and the sum of that is roughly ten hours, and that got me to where I was this morning.

* * *

[p. 2113] Q. Have you reviewed the 1977 California return for Barclays Bank International Limited?

A. I cannot recall that I have actually seen the '77 return for BBI. I'm certainly aware of a lot of things about it, but no, I do not believe I have actually seen that tax return. I have seen the BARCAL tax returns for '77. I've heard that return discussed a lot, but I have not actually seen it.

* * *

[p. 2114] THE COURT: 51-P. All right.

MR. MILAM: May I approach the witness?

THE COURT: Sure.

THE WITNESS: Yes. This confirms what I thought I knew would be true about the return.

In other words, the basis on which it's prepared.

Q. (By Mr. Milam): Okay. And would you describe to the court—

A. Yeah, I knew from other information it was prepared on a unitary basis for BBI, and I can tell from this return that it is prepared on a unitary basis for BBI.

I mean, I find apportionment factors shown here, for example. That's what I'm looking at. So that's all I know—I mean, this confirms that it was prepared using the unitary basis.

Q. Do you have an opinion on how many hours should be expended in preparation of such a return?

A. Yes. Yes, two orders of magnitude. I do have an opinion.

My opinion is it should take no more than—it should—it should take no out-of-pocket expense to prepare this because it would be prepared from readily-available information using the same approach that I used for BBL. It [p. 2115] just substitutes a different set of denominators for the factors.

In other words, it comes from information which is available at corporate level. Therefore, involves no incremental expense; only the time of the salaried employees who pull this together. And my estimation is that that should be no more than a weeks' worth of work at most. And that's at most.

Q. And what do you base that opinion on?

A. I base that—first of all, I don't believe that BBI can be in full technical compliance because I agree with Mr. Berlin's testimony that it would take, you know, a very cumbersome system to get there, and Mr. Caldwell's testimony, I agree with that. So I take it from there that they cannot be in actual full technical compliance.

There is nothing different for BBI than for BBL. If they are not in full technical compliance, then how do they get this return? They must have used reasonable approximations. If you are going to use reasonable approximations, how would you do it?

My opinion is they would do it approximately the way I did it. Again, using refinements to that as information is available, or perhaps some other refinements based on differing opinion about what is or is not material.

But essentially, they would do what I did this morning and that should take no more than a maximum of 40 hours of time to do it, and that's probably too much.

MR. MILAM: I would like this marked as Defendant's [p. 2116] Exhibit next in order, your Honor.

THE CLERK: Defense Exhibit RR.

(Whereupon Defendant's Exhibit RR was marked for identification.)

Q. (By Mr. Milam): Exhibit RR is entitled "Return Routing and Control Form."

Would you please review that for a few seconds?

A. Yes.

* * *

[p. 2117] Q. (By Mr. Milam): From your experience as an accountant, can you tell from this form what its function is?

A. I believe I can.

Q. And what is it?

A. I believe it's a summary of the time charges of the firm with regard to a particular tax return.

This is a three-year summary, 1972-1974, and the middle column which I assume is 1973— except they've left the "3" out—by inference. But the middle column is not dated.

This is a standard—quote-unquote standard—I'm sorry, this is a typical kind of a form that would be used in the accounting firm to keep track of the time spent on a particular tax return.

And you see the steps; "I interviewed the client. I prepared the return. I reviewed the return. I did some kind of computer checking." Computax is the computer system.

"If applicable." Typing and proofreading. Apparently it was not typed or proofread. We can—some of it is typed, some of it is not, so they didn't charge for typing and proofreading, and then it's processed.

It's assembled and checked by a reviewer. A manager has reviewed it. It's then signed and dated.

So this is the document showing how much time would be involved in the preparation-review of a particular tax return.

What this one relates to, it does not say which return [p. 2118] it refers to.

Q. What is the taxpayer's name at the tomorrow?

A. Taxpayer's at the top is Barclays Bank International Limited. Or what I've called BBI.

Q. And for 1972, how many hours?

A. Total time for 1972 is 21 hours.

Q. What's the total time for 1973?

A. Assuming that middle column is 1973, the total time is 12 hours.

MR. JORDAN: How can you assume that?

THE WITNESS: I'm assuming it from context, sir. It says, "1972," blank, "1974," that's why I'm assuming.

If it's not 1973—I am not trying to be nonresponsive or argumentative. I don't know what the middle column is if it's not 1973.

Q. (By Mr. Milam): And what's the total time for 1974?

A. For 1974, the column is headed, and it's 19 hours.

THE COURT: Mr. Milam, I have a little confusion. These are '72—I will assume—I will make the same assumption that it's '72, '73 and '74, but does that prove anything with reference to 1977 in terms—do I know, for instance, that there is foundation to show that these '72, '73, '74 returns of BBI were filed under the unitary method? Is that in the record?

MR. MILAM: Yes, I believe Mr. Wetzel testified that they filed on that basis from 1970 through 1981.

[p. 2119] I don't know the exact dates, but Mr. Wetzel did testify that they did it for more than ten years.

THE COURT: I'll accept your representation on that. That being so, the testimony is relevant.

* * *

Q. (By Mr. Milam): I hand you copies of Defendant's Exhibit marked for identification SS and ask you if you would take a few seconds to review those letters, [p. 2120] Professor Shank.

A. Yes, sir, I have done that.

Q. Pardon?

A. I have looked at them.

Q. Referring back to the Defendant's Exhibit RR—

A. Um-hum.

Q. —which is the one I introduced just before these letters, can you tell from these letters what service Price Waterhouse performed for each of these three years?

A. Yes, I can.

Q. Assuming that the middle year in RR is 1973?

A. Yes. These are standard transmittal letters which describe what the accountants did and any particular items they found which they feel is important to point out to the client. I can tell what they did.

The first paragraph said: "In accordance with your instructions, we have prepared and enclose, in duplicate, California franchise tax return for the year ended 9-30-72 for Barclays Bank International Limited showing a tax of" et cetera, et cetera.

"The return has been prepared on the basis of reporting the worldwide income of BBI and allocating a portion of that income to the BBI California agency according to the standard allocation formula for banks."

There is similar terminology for the other two letters.

Q. So for 1972, '73 and '74, Price Waterhouse prepared the California franchise tax return for Barclays [p. 2121] Bank; is that correct?

A. I believe that it is correct, yes, sir.

Q. Did I say "Barclays Bank of California"? If I did—

A. Then I wasn't listening. It's BBI.

Q. For Barclays Bank International Limited; is that correct?

A. (No audible response.)

MR. MILAM: Can we—I have here three pages beginning with a page dated June 15th, 1973 to Barclays Bank International, and I would like to have this marked as Defendant's next exhibit in order.

THE CLERK: Defendant's TT.

(Whereupon Defendant's Exhibit TT was marked for identification.)

Q. (By Mr. Milam): Will you take a few minutes to review these documents, Professor Shank?

A. Yes, I understand what they are now.

Q. Okay. And what are they?

A. These are statements—expense statements or fee statements. It doesn't say who—I'm assuming they go with the Price Waterhouse. That's where they got them.

It doesn't say Price Waterhouse, but it's a statement to Barclays Bank International, "Attention: Mr. Gilbert," the controller. Talking about the fees we've just talked about.

For example, the period of time covered and then the preparation of the California franchise tax return. This one [p. 2122] is for the year ended '72. This one is for the year ended—

Q. And that second one is dated June 18th, 1974?

A. Four. It's for the '73 tax return.

The next one is dated June of '75. It's for the '74 tax return.

Q. And what do those figures read?

A. $1,250 for one year; $900.00 for the second year; $1,100 for the third year.

MR. MILAM: Your Honor, may we have marked as Defendant's Exhibit next in order a two-page document, top page of which is dated June 17th, 1977, and I have one extra copy.

(Whereupon Defendant's Exhibit UU was marked for identification.)

Q. (By Mr. Milam): Would you please review that document?

A. This is similar, bills—statements to Barclays Bank International from Price Waterhouse.

The first one dated June '77 is for preparation of the franchise tax return for the year ended September 30, 1976.

Q. Which—would you read the second page?

A. I'm reading what's on the first one, the June 1977 sheet.

Q. That's the second entry?

A. Yes.

Q. Okay. What about Barclays Bank International Limited return for 1977?

[p. 2123] A. Well, by looking at it, I now see that they did not prepare it for 1977. They reviewed it. It says now, tax and accounting services for that year. "Review of the California franchise tax return for the agency for the year ended September 30, '77." Which means that the client prepared its own tax return for 1977; it was reviewed by Price Waterhouse.

Q. Would you refer to the first sheet of that statement on the first—

A. No, it's not for the year 1977. Price Waterhouse prepared the tax return.

Q. Take a look at the June 17th, 1977—

A. Review of required estimated payments under the '77 tax.

Q. So that's—estimated payments, that's different than preparing—

A. Preparing the return, that's right.

Q. So the second one, then, is the review of the actual return?

A. That's correct.

Q. And what does that tell you?

A. Well, it tells me that in addition to having spent approximately 20 hours a year or approximately a thousand dollars of compensation, Price Waterhouse's involvement with the 1977 return was cut back to a review only, which tells me that the client took on more responsibility for preparing that return.

It's not surprising. I mean, that's the way to save [p. 2124] some money. It's normal business practice for the client to take on more responsibility from the auditing firm if it can do that.

* * *

Q. (By Mr. Milam): Given your experience as an accountant and the work that you have done for this trial, do you have an opinion on whether the amount of time and expense incurred in

these last few exhibits is a reasonable estimate of the time that would be required to prepare a California worldwide combined report using reasonable approximations?

A. Yes, I do have an opinion.

Q. And what is that opinion?

A. Is that it is a reasonable estimate of the cost.

Q. By using reasonable approximations?

A. That's correct. I assume that's the only way to do it, in my opinion.

Q. Professor Shank, assuming that the Barclays Bank International California tax return for 1977 was prepared on a combined basis with Barclays Bank International Limited branches and subsidiaries operating in 55 countries, in your opinion, how much longer should it take to prepare a combined report of the entire group that operates in over 60 countries?

A. In my opinion, it should take trivially longer [p. 2125] amount of time. The only difference is what you put in the denominator of the apportionment factors and which income number you then use to apply that apportionment factor to.

It doesn't matter whether you are doing it for BBI or for BBL. It's essentially the same set of procedures.

Yes, it's somewhat more complicated because it's a bigger entity. How much should that cost in terms of preparing the return? I think—don't think it's anymore than a few more hours. In my opinion, it's certainly not millions of dollars.

Q. According to the California regulations 25137-6, the last step in determining California income is the conversion of the amount of foreign currency denominated income attributable to California into dollars.

In order to complete this step, what would an accountant have to do? Or an employee of an organization who filed a tax return?

A. For that final step, it's my understanding there are two things involved.

One is to take the foreign currency amount of earnings and multiply it by the appropriate conversion rate, which is available from the Wall Street Journal.

The second thing to do is to take that dollar amount of earnings and multiply it by the percentage.

Q. And how long would that take?

A. Well, assuming one had a Wall Street Journal to start with, it takes, I guess, a couple of minutes to look up the exchange rate at that particular date, and then 30 [p. 2126] seconds to multiply that times the percentage. So it's a few minutes, assuming one has the Wall Street Journal.

* * *

[p. 2132] A. All right. Now, you have testified before [p. 2133] today that Exhibit 14, which you have seen and which was the study prepared by Mr. Berlin of the cost of compliance with the California unitary method, do you recall seeing that?

A. This is Mr. Berlin's cost of compliance study?

Q. Right.

A. Yes, I have—I recall seeing that study.

Q. And it's true, is it not, that all the steps that Mr. Berlin has outlined in that exhibit are necessary steps to comply with the California regulations 25137-6 —

A. No, it's not.

Q. I haven't finished my question.—up to section small (e)?

A. Up to section small (e), it is correct.

Q. And everything he outlines in that exhibit, Exhibit 14, is necessary to comply with this particular regulation until you get to small (e), which is entitled—it's entitled "Application of regulation."

A. That is correct.

Well, I don't think everything—I mean, you're not asking me to give—I still think the report is estimates, but that's not what we're talking about.

I mean, do I agree except for that last section? You would have to do something much more onerous and much more expensive.

Whether you have—I agree, yes. Whether you have to do what Mr. Berlin says or not is another question.

Q. Well, let me be precise. Everything that Mr. Berlin outlines in that Exhibit Number 14 has to be done by a [p. 2134] foreign multinational corporation to comply with Section 25137-6 up until section small (e), "Application of Regulations"?

A. Yes. Everything that he says he needs as a result he would need, yes.

Q. And it's also true, is it not, that the corporation trying to comply with the regulation up through small section (e) would have no other reason whatsoever in the world to compile the data that he puts in Exhibit 14 other than to comply with the regulations?

A. If you said up to section (e), up through, not section (e), I agree.

Q. Up to, yes. Right.

A. Yes.

Q. And those—strike that.

And this would be true for every other foreign multinational corporation complying or trying to comply with Section 25137-6, that they would have no other reason to use the information that is compiled by them.

A. That's a very important question, but I certainly can't think of anything other than you can. I don't know what they do with it either other than prepare the California tax return.

* * *

[p. 2172] Q. (By Mr. Jordan): Now, if the Franchise Tax [p. 2173] Board does not accept the reasonable approximations

that you've testified to, do you know what the consequences are as far as the taxpayer is concerned?

A. I'd say if they do not, then it's very onerous. They have to go back to technical compliance—or in your words, full compliance.

Q. Now, this morning, you testified as to the water's edge regulation.

A. I want to say I don't know that—what I'm having trouble is I don't mind giving my opinions about things which I don't think factually —

(Interruption by reporter.)

THE WITNESS: Yes, I believe what I said is I have no problem giving you my opinion as long as you understand that there is a question of fact.

And I may be dead wrong. There may be some super-revenue authority in the State of California that I am totally unaware of.

What I believe is the Franchise Tax Board has the unlimited authority to accept those estimates or not, as it sees fit, and I believe that if the Franchise Tax Board failed to accept those reasonable estimates, that would leave the taxpayer in an extremely uncomfortable position of having to be in full technical compliance or failing to comply with the tax law.

Neither one of those is a very desirable consequence for the taxpayer.

* * *

[p. 2191] Q. (By Mr. Milam): In your opinion, does a foreign-based corporation or any corporation, for that matter, keep information regarding payroll, property and sales only for purposes of complying with California tax law?

A. My opinion is they do not keep such payroll, property and sales information only for purposes of complying with California tax law. They do not.

Q. There are—

A. There are other reasons.

Q. There are other reasons for keeping that information?

A. In whatever form it makes the most sense to them, yes, there would be other reasons for keeping it.